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IN THE

Supreme Court of the United States

TERUYA BROTHERS, LTD. & SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Courts of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

In 1998, a drafter of the section 1031(f) law referred the Internal Revenue Service ("IRS") to *Coastal Terminals, Inc. v. United States*, 320 F.2d 335, 336 (4th Cir. 1963) and the legislative reports after the IRS expressed concern about apparent inconsistencies within section 1031(f) of the Internal Revenue Code. In 2002, the IRS published its first and only section 1031(f) Revenue Ruling, which did *not* mention *Coastal Terminals* or the legislative purpose that can be applied to facts under the Fourth Circuit precedent but instead applied a rationale that invalidated section 1031 nonrecognition of gain treatment for a related party exchange of real property where the related party ended up with cash. The courts below in this case have relied upon similar rationales and overlooked *Coastal Terminals*.

The question presented is:

Whether the Ninth Circuit's invalidation of nonrecognition treatment here is a manifestation of Commissioner's *unconstitutional* attempt to rewrite tax law and directly contrary to: (1) the *Coastal Terminals* case, (2) the intended specific meaning of the legislative purpose that accords nonrecognition of gain treatment under section 1031(f), (3) the legal precept that the substance of a transaction should prevail over its form, and (4) a controlling tax principle in a case the Ninth Circuit cited as an authority and where this Court vacated a Ninth Circuit judgment.

RULE 29.6 STATEMENT

Pursuant to this Court's Rule 29.6, petitioner Teruya Brothers, Ltd. & Subsidiaries states that there is no parent company and there is no publicly owned company that owns ten percent or more of its stock.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

RULE 29.6 STATEMENT ii

TABLE OF AUTHORITIES viii

OPINIONS BELOW 1

JURISDICTION 2

STATUTORY PROVISIONS INVOLVED 2

STATEMENT OF THE CASE 2

I. SECTION 1031(F) AND ITS LEGISLATIVE HISTORY 2

A. Reasons for turning to legislative history 2

B. Significance of *Coastal Terminals* and the legislative reports 4

II. REVENUE RULING 2002-83 DOES NOT MENTION *COASTAL TERMINALS* AND INSTEAD RELIES UPON THE FACT THAT THE RELATED PARTY ENDED UP WITH CASH 5

III. THE TWO 1995 INDIRECT RELATED PARTY EXCHANGES 5

IV. THE TAX COURT 7

V. PRE-NINTH CIRCUIT OPINION 8

A. Commissioner acknowledged the legislative purpose that accords nonrecognition treatment under § 1031(f) and continued to reject the relevancy of *Coastal Terminals* 9

TABLE OF CONTENTS—Continued

Page

B. Teruya identified and Commissioner did not dispute the intended specific meaning of "where a taxpayer can be viewed as merely continuing his investment" 9

C. Commissioner ignored the fact that the dispositions of the relinquished properties were *required* to be terminated in the event suitable replacement properties were not found 10

D. Teruya introduced the *Tax Notes* account of the 1998 ABA Tax Section committee meeting 10

E. Teruya demonstrated that there was in substance no disposition to disregard under (f)(2)(C) for purposes of (f)(1)(C) 11

VI. NINTH CIRCUIT OPINION AND POST-DECISION PHASE 12

REASONS FOR GRANTING THE PETITION 13

I. *COASTAL TERMINALS* IS RELEVANT AND IN HARMONY WITH § 1031(F) AND ITS LEGISLATIVE HISTORY 15

II. REVENUE RULING 2002-83 TURNED A REBUTTABLE LEGISLATIVE PRESUMPTION INTO A LEGISLATIVE DETERMINATION AND CREATED FALLIBLE, UNNEEDED RATIONALES 21

TABLE OF CONTENTS—Continued

Page

A. Section 1031(f)(1)(C) is a manifestation of a rebuttable legislative presumption 23

B. The Revenue Ruling, turned a rebuttable legislative presumption into a legislative determination, rewriting § 1031(f) 25

C. The Revenue Ruling's fallible and unneeded rationales allow courts to adopt a rule of law that invalidates nonrecognition treatment under (f)(4) 26

III. TAX COURT OPINION 29

A. The Tax Court acknowledged the dispositive facts 29

B. The Tax Court committed the logical fallacy of *ignoratio elenchi* 30

C. The Tax Court committed the logical fallacy of affirming the consequent..... 30

D. The Tax Court committed the logical fallacy of red herring and linked it to the logical fallacy of affirming the consequent 32

IV. NINTH CIRCUIT OPINION 33

TABLE OF CONTENTS—Continued

Page

- A. The Ninth Circuit opinion directly conflicts with (1) the disregarded *Coastal Terminals*, (2) the ignored intended specific meaning of the acknowledged legislative purpose that accords nonrecognition treatment under § 1031(f), and (3) the legal precept that the substance of a transaction should prevail over its form 33
- B. The Ninth Circuit's economic unit rationale is an *erroneous premise* and a manifestation of Commissioner's improper transformation of a legislative presumption into a legislative determination 34
- C. The Ninth Circuit opinion conflicts with the controlling tax principle in a cited case and where this Court vacated a Ninth Circuit judgment 35

V. COMMISSIONER'S INTENT TO REWRITE THE LAW THROUGH THE COURTS APPEARS TO BE AN INTENT TO COMPROMISE THE INTEGRITY OF THE JURISPRUDENCE PROCESS 36

CONCLUSION 37

APPENDIX 1a

APPENDIX A Opinion of the Court of Appeals, Filed September 8, 2009 .... 1a

TABLE OF CONTENTS—Continued

Page

APPENDIX B Court of Appeals' Order Denying Rehearing and Rehearing *en banc*, Filed November 9, 2009 .... 21a

APPENDIX C Court of Appeals' Order Granting Motion for Stay of Mandate, Filed November 17, 2009 .... 22a

APPENDIX D Tax Court Opinion, Filed February 9, 2005 .... 23a

APPENDIX E Relevant Provisions of the Internal Revenue Code, 26 U.S.C. § 1031, Exchange of Property Held for Productive Use or Investment 40a

APPENDIX F Relevant Provisions of the Internal Revenue Code, 26 U.S.C. § 1033, Involuntary Conversions 45a

APPENDIX G Relevant Provisions of the Code of Federal Regulations, 26 C.F.R. § 1.1031(b)-2, Safe Harbor for Qualified Intermediaries 48a

APPENDIX H House Report to Accompany Omnibus Budget Reconciliation Act of 1989, Limitations on Like-Kind Exchanges 49a

APPENDIX I Revenue Ruling 2002-83, Section 1031 Exchange of Property 56a

APPENDIX J Tax Notes, ABA Tax Section-Sales, Exchanges & Basis: Recent & Future Guidance 61a

TABLE OF AUTHORITIES

CASES Page

Bolker v. Commissioner, 760 F.2d 1039 (9th Cir. 1985) 19, 20
Boulware v. United States, 128 S. Ct. 1168 (2008) 35, 36
Coastal Terminals, Inc. v. United States, 320 F.2d 335 (4th Cir. 1963), ... *passim*
Coupe v. Commissioner, 52 T.C. 394 (1969) .. 16
Esmark v. Commissioner, 90 T.C. 171 (1988), *aff'd per curiam*, 886 F.2d 1318 (7th Cir. 1989) 11
Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999) 28
Greene v. United States, 13 F.3d 577 (2nd Cir. 1994) 11
Jones v. United States, 531 F.2d 1343 (6th Cir. 1976) 28
Lucas v. Earl, 281 U.S. 111 (1930) 28
Ocmulgee Fields, Inc. v. Commissioner, 132 T.C. No. 6 (Mar. 31, 2009) 14, 36
Phillip M. Garcia v. Commissioner, 80 T.C. 491 (1983) 16
Sarkes Tazian, Inc. v. United States, 240 F.2d 467 (7th Cir. 1957) 19
S.C. Johnson & Son, Inc. v. Commissioner, 63 T.C. 778, 1975 WL 3062 (1975) 28

STATUTES

26 U.S.C. § 1031 .... *passim*
26 U.S.C. § 1031(a) 14, 21, 25, 30
26 U.S.C. § 1031(a)(1) 7, 8
26 U.S.C. § 1031(f) .... *passim*
26 U.S.C. § 1031(f)(1) 3, 5, 17, 23, 32
26 U.S.C. § 1031(f)(1)(A) .... *passim*

	Page
26 U.S.C. § 1031(f)(1)(B)	*passim*
26 U.S.C. § 1031(f)(1)(C)	*passim*
26 U.S.C. § 1031(f)(2)	*passim*
26 U.S.C. § 1031(f)(2)(A)	22
26 U.S.C. § 1031(f)(2)(B)	22
26 U.S.C. § 1031(f)(2)(C)	*passim*
26 U.S.C. § 1031(f)(4)	*passim*
26 U.S.C. § 1033	18
26 U.S.C. § 1033(a)(1)	18
26 U.S.C. § 1033(a)(2)	19
26 U.S.C. § 1033(a)(2)(B)(i)	16
26 U.S.C. § 1033(g)(1)	18
26 U.S.C. § 1033(g)(4)	16
28 U.S.C. § 1254(1)	2

OTHER AUTHORITIES

ABA Tax Section Meeting, *Officials Discuss Recent and Future Guidance on Exchanges*, 79 TAX NOTES (TA) 949 (May 25, 1998)	4, 8, 10
IRS Private Letter Ruling 200712013	9
IRS Rev. Ruling 2002-83, 2002-2 C.B. 927	5, 21, 22, 35
H.R. Conf. Rep. No. 101-386 (1989)	22, 23
H.R. Rep. 101-247, pt. 6 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906	*passim*
S. Prt. 101-56 (1989)	24

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PETITION FOR WRIT OF CERTIORARI

Petitioner, Teruya Brothers, Ltd. & Subsidiaries ("Teruya"), respectfully petitions the Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals is reported at 580 F.3d 1038, and is reprinted in the Appendix (App.") at 1a-20a. The order of the court denying rehearing and rehearing *en banc* appears at App. 21a and the order staying the mandate for a thirty (30) day period appears at App. 22a. The court of appeals affirmed the February 9, 2005 decision of the Tax Court (App. 23a-39a) reported at 124 T.C. 45 (2005).

JURISDICTION

The judgment of the court of appeals was entered on September 8, 2009, and a timely petition for rehearing and rehearing *en banc* was denied on November 9, 2009. The court's order granting a stay of mandate was entered on November 17, 2009. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of Section 1031 of the Internal Revenue Code (26 U.S.C. § 1031 Exchange of Property Held for Productive Use or Investment), are reproduced at App. 40a-44a.

STATEMENT OF THE CASE

I. SECTION 1031(F)[1] AND ITS LEGISLATIVE HISTORY

Congress enacted special rules for exchanges between related party, § 1031(f), in 1989—twenty years ago.

The government has yet to publish any regulations clarifying the meaning of this part of the Internal Revenue Code.

A. Reasons for turning to legislative history

Section 1031(f)(1) provides that in general, if (A) a taxpayer exchanges property with a related person AND (B) there is § 1031 nonrecognition of gain or loss to the taxpayer with respect to the exchange of such property AND (C) within two years of the last transfer of the exchange the related party disposes of such property or the taxpayer disposes of the property received in the exchange from related party, then the nonrecognition treatment to the taxpayer shall be invalidated. App. 43a.

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[1] All section references are to the Internal Revenue Code ("Code") as in effect for the taxable years in issue and as amended.

The (f)(1) general rule plainly has two faces: the (f)(1)(A)(B) face, which preserves nonrecognition treatment, and the (f)(1)(C) face, which invalidates nonrecognition treatment. That is, if there is a disposition of exchange property within two years of the (f)(1)(A)(B) exchange, nonrecognition treatment is invalidated.

Under § 1031(f)(2), certain kinds of dispositions are not taken into account for purposes of § 1031(f)(1)(C). Such dispositions under § 1031(f)(2)(C) would be those with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax. App. 43a-44a.

Since both (f)(1)(C) and (f)(2)(C) dispositions occur within two years of a related party exchange, how is the (f)(1)(C) disposition, which invalidates nonrecognition treatment, to be distinguished from a (f)(2)(C) disposition, which preserves nonrecognition treatment? This question is a reason to turn to the legislative reports.

Section 1031(f)(4) provides that § 1031 will not apply to any exchange which is part of a transaction (or series of transactions) *structured to avoid the purposes* of § 1031(f). App. 44a.

Since (f)(1)(C) applies only where there is an exchange of property between related parties (see (f)(1)(A)), the issue where the related party sold, not exchanged its property, is whether (f)(4) applies. That is the issue here.

What are the purposes of § 1031(f)? This question is another reason to turn to legislative history.

B. Significance of *Coastal Terminals* and the legislative reports

In 1998, a drafter of the § 1031(f) law referred the Internal Revenue Service ("IRS") to a Fourth Circuit case and the legislative reports. At the May 16, 1998 meeting of the Sales, Exchanges, and Basis Committee of the American Bar Association Tax Section, Kelly Alton, then IRS special counsel to the Assistant Chief Counsel (Income Tax & Accounting), said that the government was troubled by the inconsistency between § 1031(f)(2) and § 1031(f)(4). ABA Tax Section Meeting, *Officials Discuss Recent and Future Guidance on Exchanges*, 79 TAX NOTES (TA) 949 (May 25, 1998). App. 61a.

Adam Handler, the incoming committee chair and one of the drafters of the § 1031(f) law, said he was "troubled by the confusion" and directed her to "the *Coastal Terminal* decision and the committee reports on the provision." *Id.* App. 61a-62a.

In *Coastal Terminals, Inc. v. United States*, 320 F.2d 335 (4th Cir. 1963), the Court of Appeals for the Fourth Circuit affirmed a lower court's decision that the corporate taxpayer did not "cash out" but merely continued its investment. The fact that the taxpayer from the outset had not agreed taxpayer's relinquished property could be sold for cash was dispositive.

II. REVENUE RULING 2002-83 DOES NOT MENTION *COASTAL TERMINALS* AND INSTEAD RELIES UPON THE FACT THAT THE RELATED PARTY ENDED UP WITH CASH

In 2002, IRS published a revenue ruling on § 1031(f), which did not mention the *Coastal Terminals* case. Revenue Ruling 2002-83, 2002-2 C.B. 927 (App. 56a-60a) held that under the facts described in the Ruling:

> . . . *a taxpayer* who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party *is not entitled to nonrecognition treatment* under § 1031(a) of the Internal Revenue Code *if*, as part of the transaction, *the related party receives cash or other non-like-kind property* for the replacement property. (emphasis added).

The Revenue Ruling's "related party ended up with cash" rationale treats a taxpayer as having "cashed out" of his investment where the related party ended up with cash or property not of like-kind. The fact that the related party ended up with cash is used to invalidate nonrecognition treatment pursuant to § 1031(f)(4) on the grounds that the taxpayer structured the transaction with a qualified intermediary ("QI") "to avoid the application of § 1031(f)(1)." App. 59a. The Ruling does not mention (f)(2) at all.

III. THE TWO 1995 INDIRECT RELATED PARTY EXCHANGES

Petitioner Teruya is a consolidated group of Hawaii corporations incorporated in 1947. One of its business activities is the purchasing and development of residential and commercial real property.

During the taxable year in issue, Teruya owned 62.5 percent of the common shares of Times Super Market, Ltd. ("Times"), and thus Teruya and Times were "related persons" for purposes of § 1031(f). Teruya and Times filed separate tax returns.

In 1995, Teruya and Times engaged in two separate real property like-kind exchange transactions with unrelated third parties: the Ocean Vista transaction and the Royal Towers transaction.

Teruya entered into two separate contracts to sell its Ocean Vista and Royal Towers properties (the relinquished properties) to unrelated parties contingent on Teruya finding suitable replacement property to accomplish a § 1031 exchange. The replacement properties were from its related party, Times. These exchanges were facilitated with the use of a qualified intermediary ("QI"). Times sold the replacement properties to the QI.

The exchange agreement language in each transaction required the termination of the acquisition of the relinquished property as well as the exchange agreement itself if suitable replacement property were not found. App. 26a-29a. Such language meant that either the relinquished properties were to be exchanged or not disposed at all.

Teruya from the outset had no interest in selling the relinquished properties for cash. In the Ocean Vista transaction, as early as 1993, when the acquirer of Teruya's Ocean Vista property inquired about buying the relinquished property, Teruya stated that it was "not available" for sale and, shortly thereafter, indicated that it might be sold only if an exchange property could be found. App. 25a. In the Royal Towers transaction, *before* Teruya entered into the December 12, 1994 agreement to sell Royal Towers subject to the consummation of a § 1031 exchange, Teruya had signed a September 6, 1994 letter of intent with Times to acquire the replacement properties subject to a § 1031 exchange. App. 28a.

Under § 1031(a)(1), Teruya deferred $1,345,169 in realized gain from the Ocean Vista transaction and $10,700,878 in realized gain from the Royal Towers transaction. App. 30a.

IV. THE TAX COURT

On October 20, 2003, Teruya petitioned the United States Tax Court in response to an IRS notice of deficiency that Teruya must recognize $12,041,026 in gains.

In its opinion, the court concluded that since Teruya failed to satisfy the (f)(2)(C) standard, its transactions violated (f)(4), and accordingly invalidated nonrecognition treatment. App. 23a-39a.

The court acknowledged the above facts about each transaction.

The court also acknowledged Teruya's contention about its intent:

> With respect to both the Ocean Vista and Royal Towers transactions, petitioner contends that "there was no intent to disguise an actual sale of the relinquished property in order to reduce or avoid gain recognition on such sale, because a sale of the relinquished property was not intended in the first place." App. 36a.

However, the court disregarded such intent and the precedents Teruya cited, including *Coastal Terminals*, upon the grounds that they had "little relevance" here. Citing § 1031(f)(1)(B) (App. 37a), the court stated § 1031(f) presupposes a related party exchange successfully met the requirements of § 1031(a)(1). App. 37a.

Teruya had not yet introduced 79 Tax Notes (TA) 949 which indicates that Coastal Terminals is relevant. App. 61a-62a.

In interpreting the law, the court stated that "any inquiry into whether a transaction is structured to avoid the purposes of § 1031(f) should also take . . . [the § 1031(f)(2)(C)] exception into consideration." App. 34a-35a.

Nonetheless, the court stated:

> These transactions are economically equivalent to direct exchanges of properties between Teruya and Times . . . followed by Times's sales of the properties to unrelated third parties. The interposition of a qualified intermediary in these transactions cannot obscure the *end result*. App. 35a.

(emphasis added.)

V. PRE-NINTH CIRCUIT OPINION

On June 9, 2005, Teruya filed a timely Notice of Appeal with the Tax Court whereby Teruya appealed to the Ninth Circuit from the final decision of the Tax Court entered on February 15, 2005, following a March 18, 2005 order denying Motion to Vacate Decision.

A. Commissioner acknowledged the legislative purpose that accords nonrecognition treatment under § 1031(f) and continued to reject the relevancy of *Coastal Terminals*

In a March 23, 2007 Private Letter Ruling (200712013), the IRS acknowledged the very legislative purpose Teruya had relied upon before the Tax Court and which the court overlooked: "Section 1031(f) was . . . enacted to accord nonrecognition treatment only to exchanges . . . where a taxpayer can be viewed as merely continuing his investment . . . . *See* H.R. REP. NO. 101-247, at 1341 [*sic*] (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2811."

In the February 19, 2008 answering brief the Commissioner of Internal Revenue ("Commissioner") re-acknowledged the legislative purpose that accords nonrecognition treatment under § 1031(f).

Despite acknowledging the legislative intent to accord nonrecognition treatment under § 1031(f) only to exchanges where a taxpayer *can be viewed* as *merely continuing* his investment, Commissioner continued to reject *Coastal Terminals* where the Fourth Circuit concluded the taxpayer *did not "cash out"* but *merely continued* its investment.

B. Teruya identified and Commissioner did not dispute the intended specific meaning of "where a taxpayer can be viewed as merely continuing his investment"

In the November 19, 2007 Ninth Circuit opening brief, Teruya demonstrated that the intended specific meaning of the legislative purpose that accords nonrecognition treatment under § 1031(f) is "where a taxpayer from the outset had no right to cash or property not of like-kind."

Commissioner did not acknowledge or dispute the intended specific meaning identified by Teruya in the answering brief. Nor at oral argument did the government acknowledge or dispute such intended specific meaning.

C. Commissioner ignored the fact that the dispositions of the relinquished properties were *required* to be terminated in the event suitable replacement properties were not found

At footnote 6 of the answering brief, Commissioner did *not* state that the dispositions of the relinquished properties were *required* to be terminated in the event suitable replacement properties were not found, but stated only that the exchanges were to be terminated. In so ignoring such legal requirement, Commissioner suggested that the Teruya transactions were like most other exchanges where taxpayers are legally obligated to sell the relinquished property for cash if the exchange is not accomplished.

D. Teruya introduced the *Tax Notes* account of the 1998 ABA Tax Section committee meeting

In the May 14, 2008 reply brief, Teruya rebutted Commissioner's argument that *Coastal Terminals* was not applicable here by referring for the first time to the Tax Notes, *Id.*, account of the 1998 ABA Tax Section committee meeting where a drafter of § 1031(f) directed IRS to *Coastal Terminals* and the legislative reports. *See* Statement of the Case ("Statement"), *supra*, at I.B.

Commissioner did not dispute this account at oral argument. The Ninth Circuit did not even ask the government about it.

E. Teruya demonstrated that there was in substance no disposition to disregard under (f)(2)(C) for purposes of (f)(1)(C)

In an April 11, 2009 FRAP 28(j) letter, Teruya applied to the jointly stipulated facts acknowledged by the Tax Court (App. 25a-29a) the interdependence test of the Step Transaction Doctrine, which is a variation of the legal precept that the substance of a transaction should prevail over its form. Under this test, the steps in each Teruya transaction collapsed into merely an exchange since each step did not have any independent significance but rather had meaning only as parts of an exchange.

Teruya also stated that any attempt to recharacterize each Teruya transaction into a related party exchange of property *followed by* a disposition of the exchange property would be contrary to settled case law that prohibits adding a step to assert a tax liability. *Greene v. United States*, 13 F.3d 577, 583 (2nd Cir. 1994); *Esmark v. Commissioner*, 90 T.C. 171, 196-197 (1988), *aff'd per curiam*, 886 F.2d 1318 (7th Cir. 1989).

Teruya further stated that since there is in substance no (f)(1)(C) disposition here to disregard under (f)(2)(C), Teruya is not required to carry the burden of proof under (f)(2)(C), and its transactions are presumed not to have avoided Federal income taxes.

VI. NINTH CIRCUIT OPINION AND POST-DECISION PHASE

On September 8, 2009, the Ninth Circuit affirmed the determination of the Tax Court, stating that the two 1995 exchange transactions were structured to avoid the purposes of § 1031(f), and thus violated § 1031(f)(4). App. 1a-20a.

The Ninth Circuit held that Teruya had "cashed out" of its investments "in contravention of Congress's desire that nonrecognition treatment only apply to transactions 'where a taxpayer *can be viewed* as *merely continuing* his investment.'" App. 15a-16a. (emphasis added).

In acknowledging the legislative intent that accords nonrecognition treatment under § 1031(f), the Ninth Circuit opinion differs from that of the Tax Court and agrees with the government and Teruya's positions.

However, the Ninth Circuit ignored the intended specific meaning of the acknowledged legislative purpose that accords nonrecognition treatment under § 1031(f) generally only where a taxpayer *can be viewed as merely continuing* his investment. Statement, *supra* at V.B.

The court also disregarded the *Coastal Terminals* case and overlooked the application of the interdependence test of the Step Transaction Doctrine, which had earlier established that the Teruya transactions were in substance merely § 1031(f)(1)(A)(B) exchanges. Statement, *supra* at V.E.

The premise that taxpayer and related party *should be* treated as an economic unit under (f)(4) is the foundation of the Court's analysis and conclusion.

> [The Teruya] . . . exchanges may only be denied nonrecognition treatment if they were "part of a transaction (or series of transactions) structured to avoid the purposes of [§ 1031(f)]." § 1031(f)(4). App. 12a.
>
> * * *
>
> Congress's concern about related taxpayers acting in concert, as well as the House Report's admonition that exchanges should not be accorded nonrecognition treatment where "the related *parties* have, in effect, 'cashed out' of" the investment," H.R. Rep. No. 101-247, pt. 6, at 1340 (emphasis added), confirm that *the taxpayer and the related party should be treated as an economic unit in this inquiry*. App. 15a. (underline added).

The Court's conclusion rests upon two pillars: the QI rationale (App. 16.a) and the "advantageous tax consequences" rationale (App. 19a).

In describing the facts of each transaction, the Ninth Circuit ignored the legal requirement to terminate the dispositions of the relinquished properties and thereby suggested, as Commissioner did (Statement, *supra*, at V.C), that the Teruya transactions were like most other exchanges where taxpayers are legally obligated to sell the relinquished property for cash if suitable replacement property is not found. App. 4a, 6a.

REASONS FOR GRANTING THE PETITION

If this Court does not grant this petition, Commissioner, in this case of first impression, will have succeeded in usurping the legislative power vested in Congress to make law, and will commit an abuse of the separation of powers that the United States Constitution was designed to prevent.

One of the legislative purposes of § 1031(f) is to accord § 1031(a) nonrecognition of gain treatment generally only to an exchange where a taxpayer can be viewed as merely continuing his investment. Whether this legislative purpose as applied here to the *stipulated* facts (App. 24a) has been carried out when viewed under a Fourth Circuit precedent that directly addressed the central issue, or under the intended specific meaning of such legislative purpose, or under the legal precept that the substance of a transaction should prevail over its form, the conclusion is the same: The corporate taxpayer merely continued its investments as a matter of law.

If this is such a simple case, why are we here?

We are here because the IRS in a revenue ruling transformed legislative presumption into legislative determination in the apparent hope that courts will ultimately rely upon the rationales in the ruling to rewrite § 1031(f).

In *Ocmulgee Fields, Inc. v. Commissioner*, 132 T.C. No. 6 (Mar. 31, 2009) on appeal in the Eleventh Circuit, the appellant taxpayer identified in its September 28, 2009 opening brief at page 25, the contest between a created rule and one enacted by Congress: A "hypothetically-based 'end result' test" is being "substituted" for the "section 1031(f)(4) intent-based 'structured to avoid' standard Congress enacted."

We are also here because the Tax Court and the Ninth Circuit committed the logical fallacies of *ignoratio elenchi*, affirming the consequent, and red herring in advancing the IRS's manufactured § 1031(f) rationales.

Section 1031(f) is the child of a beautiful masterpiece of legislative language that provides the intended, *specific* meaning of § 1031(f).

It is to this beauty we turn for the authority in order to ascertain the fidelity of the opinions below, as well as the positions of the IRS and the taxpayer, to the legislative text.

I. *COASTAL TERMINALS* IS RELEVANT AND IN HARMONY WITH § 1031(F) AND ITS LEGISLATIVE HISTORY

In 1998, a drafter of § 1031(f) informed the IRS that *Coastal Terminals* and the legislative reports were pertinent to the proper understanding of such law. Statement, *supra* at I.B.

Coastal Terminals is in harmony with § 1031(f) and its legislative history because it addressed the issue at the heart of § 1031(f). The Fourth Circuit affirmed a lower court's decision that the corporate taxpayer did not "cash out" but merely continued its investment. The fact that the taxpayer from the outset had not agreed taxpayer's relinquished property could be sold for cash was dispositive.

One of Congress's primary reasons for enacting § 1031(f) was its belief "that the 'like-kind' standard as applied to exchanges of property [wa]s too broad." H.R. Rep. No. 101 247, pt. 6, 1340 (1989). App. 51a. "Under present law, taxpayers have been granted nonrecognition treatment under section 1031 and 1033(g) (relating to condemned real property) in circumstances where they have significantly changed their investment as a result of the exchange or conversion." *Id*. App. 51a.

The phrase "where they have significantly changed their investment as a result of the exchange or conversion" was intended to mean, "where a taxpayer *from the outset had* a right to cash or property not of like-kind." Section 1033(g)(4) refers to § 1033(a)(2)(B)(i), which is the statutory deadline of the period within which like-kind replacement property can be purchased in order to *avoid* the recognition of gain where a taxpayer from the outset *had* a right to cash or property not of like-kind. App. 45a-47a.

Similarly, a bona fide § 1031 exchange can avoid the recognition of gain even where a taxpayer *had* an *initial* right to cash and *retained* such right to a cash sale where the exchange is not accomplished. *Coupe v. Commissioner*, 52 T.C. 394, 405 (1969) ("It is now well settled that when a taxpayer who is holding property for productive use in a trade or business enters into an agreement to sell the property for cash, but before there is substantial implementation of the transaction, arranges to exchange the property for other property of like-kind, he receives the nonrecognition benefits of section 1031"). *Phillip M. Garcia v. Commissioner*, 80 T.C. 491, 498 (1983) ("[In] . . . *Mercantile Trust Co. of Baltimore v. Commissioner*, 32 B.T.A. 82 (1935) . . . [the] Board did not deem the possibility of a sale fatal to a finding of an exchange where the conditions required to animate an intent to exchange had been met . . . . Cases decided since *Mercantile Trust Co. of Baltimore* have followed the pattern of ignoring alternative sales possibilities where a preference for exchange was manifest and exchange actually occurred").

Accordingly, it is reasonable to infer that Congress believed the "like-kind" standard as applied to exchanges of property was too broad because such standard accorded nonrecognition treatment even where a taxpayer from the outset had a right to cash or property not of like-kind and thus where he, in effect, used the exchange to avoid the recognition of gain on a contracted sale of his relinquished property. In such situations, a bona fide § 1031 exchange had, in effect, disguised a sale of the relinquished property and reinvestment of the sale proceeds in the acquisition of the replacement property.

Congress wished to narrow the nonrecognition standard for § 1031(f) exchanges: The House committee believed "it is appropriate to accord nonrecognition treatment only to exchanges . . . where a taxpayer can be viewed as merely continuing his investment."[2] H.R. Rep. No. 101 247, pt. 6, 1340 (1989). App. 51a.

The "can be viewed as merely continuing taxpayer's investment" legislative purpose is manifest in the first of two faces of the § 1031(f)(1) general rule. The first face—§ 1031(f)(1)(A)(B) exchange—*preserves* nonrecognition treatment because *no* disposition of exchange property occurs within two years of such related party exchange. App. 43a.

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[2] The narrowing of "like-kind" nonrecognition treatment generally only to exchanges where a taxpayer can be viewed as merely continuing his investment was initially proposed to apply to *all* § 1031 exchanges. Had such proposed change not been withdrawn in conference committee, § 1031(f) would have been rendered meaningless: Since every exchange would have been required to satisfy the "merely continuing taxpayer's investment" standard to qualify for the nonrecognition treatment precondition (*i.e.*, § 1031(f)(1)(B); App. 43a), invalidation of nonrecognition treatment under § 1031(f) would have been impossible.

The "can be viewed as merely continuing taxpayer's investment" legislative purpose is also manifest even where a disposition of exchange property occurs within two years of a related party exchange, *provided* such disposition is disregarded, for example, under § 1031(f)(2)(C) for purposes of § 1031(f)(1)(C). App. 43a-44a. With such disposition disregarded, the transaction is merely a § 1031(f)(1)(A)(B) exchange. Accordingly, the plain language of § 1031(f) provides that a taxpayer can be viewed as *merely continuing his investment even where* his relinquished property is *disposed* to an unrelated party *within two years* of the exchange!

Since both (f)(1)(C) and (f)(2)(C) dispositions occur within two years of a related party exchange, how is the (f)(1)(C) disposition, which invalidates nonrecognition treatment, to be distinguished from a (f)(2)(C) disposition, which preserves nonrecognition treatment?

The intended specific meaning of the "merely continuing taxpayer's investment" legislative purpose identifies the fact that manifests taxpayer's intent to merely continue his investment. The House report went on to state, the "'similar or related in service or use' standard contained in § 1033 (relating to involuntary conversions) better describes the types of transactions that the committee wishes to accord nonrecognition treatment." *Id.* App. 51a.

The "similar or related in service or use" standard (*i.e.*, § 1033(a)(1) (*Conversion into similar property*)) is one of two § 1033 standards. Under this standard, nonrecognition of gain treatment is obtained if property is converted directly into property similar or related in service or use to the property converted, which is defined under § 1033(g)(1) as "property of a like kind to be held either for productive use in trade or business or for investment." App. 45a.

In comparison, its sister, the "money or property not similar or related in service or use" standard (*i.e.*, § 1033(a)(2) (*Conversion into money*)), provides, in effect, that the recognition of gain can be avoided even where a taxpayer has an initial right to cash, provided the cash is used to purchase like-kind property within a statutory time period. App. 45a-46a.

Based upon the above, the *intended specific meaning* of the phrase "where a taxpayer can be viewed as merely continuing his investment" is "*where a taxpayer from the outset had no right to cash or property not of like-kind.*"[3]

This intended specific meaning identifies the dispositive fact that manifests taxpayer's intent to merely continue his investment. "Intent is to be ascertained from all relevant facts and circumstances, and of necessity the case is largely dependent upon circumstantial evidence." *Coastal Terminals*, 320 F.2d at 337, quoting *Sarkes Tazian, Inc. v. United States*, 240 F.2d 467, 470 (7th Cir. 1957).

This intended specific meaning was intended to be applied to the facts and circumstances under a rule of law laid down in *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985) to determine whether a *disposition* of property within two years of a related party exchange of the property may be *disregarded under* (f)(2)(C) for purposes of (f)(1)(C) *on the grounds that the taxpayer merely continued his investment*. The analysis in *Bolker* was intended to be an "authority" (App. 52a) for disregarding disposition under a proposed one-year holding period rule[4] that would have required, among other things, any exchange property to be held for one year immediately after the exchange in order for the exchange to qualify for § 1031 nonrecognition treatment. H.R. Rep. No. 101 247, pt. 6, 1339-1342 (1989). App. 50a-55a.

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[3] This intended specific meaning was first identified in Teruya's Ninth Circuit opening brief filed on November 19, 2007.

Under the proposed rule a disposition was intended to be disregarded where the non-tax avoidance (f)(2)(C) standard was satisfied: The House committee report stated that disposition rules "described above with respect to related party dispositions will apply for purposes of the one-year holding period" (*Id.*, 1342). App. 55a. *Bolker*, 760 F.2d at 1045, sets forth the rule of law ("*Bolker rule*") that "if a taxpayer owns property which he does *not intend* to liquidate . . . the *intent to exchange* property for like-kind property satisfies the holding requirement, because it is *not an intent to liquidate* the investment." Accordingly, if a taxpayer had no intent to liquidate his relinquished property as manifested by the fact that with respect to such property he from the outset had *no* right to cash or property not of like-kind, the disposition of the relinquished property within two years of the related party exchange does *not* violate the "within two year holding" period of § 1031(f)(1)(C).[5] App. 43a.

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[4] The proposed one-year holding period rule was not in the Senate amendment, which was adopted by the Conference Committee.

[5] The enactment of the proposed one-year holding period rule for all exchanges would have practically obviated the need for § 1031(f): Had the rule been enacted, most, if not all, exchanges satisfying the nonrecognition treatment precondition for the application of § 1031(f) (*i.e.*, § 1031(f)(1)(B)) would also satisfy the non-tax avoidance (f)(2)(C) standard.

Either a bona fide § 1031(a) exchange that avoids recognition of gain or an exchange that merely continues a taxpayer's investment may satisfy the § 1031(a) nonrecognition treatment precondition before § 1031(f) can be applied. *See* § 1031(f)(1)(B). App. 43a. This is the *first* and *broad* § 1031 "test."

However, under § 1031(f), nonrecognition treatment is preserved generally only where a taxpayer can be viewed as merely continuing his investment. This is the *second* and *narrow* § 1031 "test."

Based upon the above, the intended specific meaning of the phrase, "can be viewed as merely continuing his investment," is in harmony with the dispositive fact in the *Coastal Terminals* case.

The phrase also signifies that *the Fourth Circuit case cannot be disregarded without also disregarding legislative intent.*

II. REVENUE RULING 2002-83 TURNED A REBUTTABLE LEGISLATIVE PRESUMPTION INTO A LEGISLATIVE DETERMINATION AND CREATED FALLIBLE, UNNEEDED RATIONALES

Apparently, the IRS chose not to rely upon the analysis in *Coastal Terminals* or upon the legislative purpose that accords § 1031 nonrecognition treatment under 1031(f). In 2002, IRS published Revenue Ruling 2002-83, *id.*, which did not mention *Coastal Terminals* or the aforementioned legislative purpose. Instead the ruling applied a created, fallible and unneeded rationale after transforming a legislative presumption into a legislative determination.

To repeat, the Revenue Ruling's "related party ended up with cash" rationale (Statement, *supra* at II) treats the taxpayer as having "cashed out" of his investment where the related party ended up with cash or property not of like-kind. The fact that the related party ended up with cash is used to invalidate nonrecognition treatment pursuant to § 1031(f)(4) on the grounds that the taxpayer structured the transaction with a qualified intermediary ("QI") to avoid the purposes of § 1031(f). App. 60a.

The Revenue Ruling's reasoning conflicts with § 1031(f)(2). The fact that a related party ended up with cash is *not sufficient* reason to invalidate nonrecognition treatment under § 1031(f): The plain language of (f)(2) indicates that nonrecognition treatment is *not* invalidated even where the related party ends up with cash as a result of a disposition of exchange property within two years of a related party exchange, because for certain kinds of transactions qualifying under (f)(2), such disposition is disregarded for (f)(1)(C) purposes.[6] App. 43a-44a.

Furthermore, the fact that a related party ended up with cash is not sufficient reason to conclude nonrecognition treatment should be invalidated under § 1031(f)(4). After all, a QI can facilitate a § 1031(f)(2)(C) transaction, where even if a related party ends up with cash, nonrecognition treatment is not invalidated. Moreover, the Conference Committee report clearly provides that a disposition within two years of an *indirect* related party exchange will generally be disregarded if it satisfies the non-tax avoidance exception (*i.e.*, the (f)(2)(C) standard):

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[6] *See* sections 1031(f)(2)(A), (f)(2)(B), and (f)(2)(C). App. 43a-44a. Since the (f)(2)(C) non-tax avoidance exception was intended generally to apply to transactions involving exchanges of undivided interests (101 H.R. Conf. Rep. No. 386, at 614 (1989)) where typically the related party ends up with cash, a related party's disposition of exchange property for cash within two years of the exchange is *not sufficient* reason to invalidate nonrecognition treatment.

> If a taxpayer directly or *indirectly* exchanges property with related party in a section 1031 exchange, and within two years either the related party or the taxpayer disposes of the property, the original exchange will not qualify for nonrecognition under section 1031 . . . . However, dispositions due to death, involuntary conversion, or for *non-tax avoidance purposes* generally are *disregarded*. 101 H.R. Conf. Rep. No. 386, at 614 (1989) ("Related party exchanges") (emphasis added).

Evidently, the IRS responded to the challenge posed by (f)(2)(C) by, in part, ignoring (f)(2): The Revenue Ruling did not mention (f)(2) at all!

More significantly, the Revenue Ruling responded to the challenge posed by (f)(2)(C) by turning a legislative presumption into a legislative determination as the following analysis demonstrates.

A. Section 1031(f)(1)(C) is a manifestation of a rebuttable legislative presumption

Section 1031(f)(1)(C) is plainly a child of a rebuttable legislative presumption: First, (f)(1)(C) is the second of two faces of (f)(1), which begins with the words "in general." App. 43a. Second, a (f)(1)(C) disposition triggers invalidation of nonrecognition treatment *unless* the disposition is disregarded for (f)(1)(C) purposes under the (f)(2) exception. App. 43a-44a.

Further confirmation that (f)(1)(C) is a manifestation of a rebuttable legislative presumption is provided by the phrase, "The committee believes," in the following excerpt from the legislative reports:

> Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale . . . . The *committee believes* that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment. H.R. Rept. No. 101 247, pt. 6, at 1340 (1989); S. Prt. No. 101-56, 101st Cong., 1st Sess. 151 (1989). App. 51a. (emphasis added).

The legislative presumption is actually about the *original owner* of the *relinquished property* (who we shall call, for simplicity purposes, the taxpayer). First, it is self-evident that where a related party disposes of the relinquished property to an unrelated buyer for cash shortly after a related party exchange of the property, the related party actually "cashes out" of her investment. Accordingly, whether "related *parties* have, in effect, "cashed out" of the investment" (emphasis added) depends upon whether the taxpayer has, in effect, "cashed out" of his investment *with respect to the relinquished property*.

Second, it is reasonable to infer from the above excerpt that the committee presumed the taxpayer anticipated the recognition of gain on the sale of his low basis property, and he, in order to reduce or avoid such recognition of gain, obtained nonrecognition of gain treatment by means of a bona fide § 1031(a) exchange of his low basis property for related party's high basis property, followed shortly thereafter by the related party's disposition of the low basis property to an unrelated buyer for cash. It is reasonable to infer that the committee believed the taxpayer, in effect, accomplished—under the cover of a bona fide § 1031(a) exchange of property followed shortly thereafter by the disposition of the property—the contracted sale of his relinquished property and reinvestment of the sale proceeds in the acquisition of the replacement property from the related party.

Simply stated, the (f)(1)(C) disposition is a manifestation of a rebuttable *legislative presumption* that the *taxpayer anticipated* the recognition of gain on his low basis *relinquished property*.

Accordingly, since (f)(1)(C) is a child of the aforementioned legislative presumption, a facts and circumstances determination *rebutting* such *legislative presumption satisfies* the *(f)(2)(C)* exception to (f)(1)(C). After all, a disposition of exchange property within two years of a related party exchange is disregarded under (f)(2)(C) for (f)(1)(C) purposes. App. 43a-44a.

B. The Revenue Ruling turned a rebuttable legislative presumption into a legislative determination, rewriting § 1031(f)

The Revenue Ruling turned the aforementioned rebuttable legislative presumption into a legislative determination by truncating a key sentence in the above excerpt. In the *following* excerpt from the Revenue Ruling, the Ruling removed the phrase, "The committee believes that," which precedes "if a related party exchange . . . " in the *above* excerpt:

> The legislative history underlying § 1031(f) states that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." H.R. Rep. No. 247, 101st Cong. 1st Sess. 1340 (1989). App. 58a-59a.

With the truncation and the legislative phrase, "the related parties have, in effect, 'cashed out' of the investment," the fact that the related party ended up with cash became the apparently sufficient reason for determining that the taxpayer "cashed out" of his investment. Accordingly, with such truncation, the Revenue Ruling turned a rebuttable legislative presumption into an apparently absolute legislative determination and thereby rewrote the law.

C. The Revenue Ruling's fallible and unneeded rationales allow courts to adopt a rule of law that invalidates nonrecognition treatment under (f)(4)

With the aforementioned truncation, the Revenue Ruling rewrote § 1031(f) and created the *fallible* and *unneeded* "related party ended up with cash" rationale and the implicit, underlying economic unit rationale. The latter rationale essentially means that the taxpayer and related party *should be* treated as a single economic unit.

First, as demonstrated above, the "related party ended up with cash" rationale is contradicted by (f)(2) as well as by the fact that a QI can facilitate a (f)(2)(C) transaction.

Second, contrary to the economic unit rationale, simple logic dictates that if a taxpayer did not "cash out" but merely continued his investment as a matter of law, the related *parties* (*i.e., both* taxpayer and the related party) could not have "cashed out" of the investment.

Third, based upon the above, the inquiry about whether or not the taxpayer "cashed out" or merely continued his investment should properly begin *not* with whether or not the related party ended up with cash but rather with whether or not the *taxpayer* from the outset had a right to cash or property not of like-kind.

If the taxpayer from the outset had no right to cash or property not of like-kind, he as a matter of law did not "cash out" but merely continued his investment (Reasons, *supra*, I), and in compliance with the legislative purpose that accords nonrecognition treatment under § 1031(f), nonrecognition treatment should not be invalidated pursuant to (f)(1)(C) or (f)(4).

On the other hand if a taxpayer from the outset had a right to cash or property not of like-kind, the legislative presumption that he anticipated the recognition of gain on his low basis relinquished property applies to invalidate nonrecognition treatment pursuant to (f)(1)(C) or (f)(4) *unless* such presumption is rebutted under the (f)(2)(C) standard.

Finally, the "related party ended up with cash" rationale and the underlying economic unit rationale are *unneeded* because the *anticipatory assignment of income doctrine* and simple logic applied to facts and circumstances can either affirm or rebut the legislative presumption that the taxpayer anticipated the recognition of gain on his low basis relinquished property.

The anticipatory assignment of income doctrine was first enunciated by this Court in *Lucas v. Earl*, 281 U.S. 111 (1930), and later by the Ninth Circuit in *Ferguson v. Commissioner*, 174 F.3d 997, 1003-1004 (9th Cir. 1999):

> Under the anticipatory assignment of income doctrine, once a right to receive income has "ripened" for tax purposes, the taxpayer who earned or otherwise created that right, will be taxed on any *gain* realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income. *See Jones v. United States*, 531 F.2d 1343, 1346 (6th Cir.1976); (citations omitted) . . . . To determine whether a right has "ripened" for tax purposes, a court must consider the realities and substance of events to determine whether the receipt of income was practically certain to occur (*i.e.*, whether the right basically had become a *fixed* right). *See, e.g., Jones*, 531 F.2d at 1346 . . . . [T]he finding of a mere anticipation or expectation of the receipt of income has been deemed insufficient to conclude that a fixed right to income existed, *see, e.g., S.C. Johnson & Son, Inc. v. Commissioner*, 63 T.C. 778, 787-88, 1975 WL 3062 (1975) . . . . (emphasis added).

For example, a facts and circumstances determination might establish that though a taxpayer from the outset had a right to cash, such right was not a fixed right to *income* (*i.e.*, gain) because the taxpayer anticipated zero gain or a loss on the anticipated sale of his relinquished property.

Alternatively, a facts and circumstances determination that a taxpayer from the outset had a fixed right to income confirms the legislative presumption, and nonrecognition treatment is invalidated under (f)(1)(C) or (f)(4) *unless* the taxpayer's relinquished property was *not* the low basis property.

Accordingly, the created, fallible "related party ended up with cash" and economic unit rationales are unneeded because the anticipatory assignment of income doctrine and simple logic applied to facts and circumstances can either confirm or rebut the legislative presumption that the taxpayer anticipated the recognition of gain on his low basis relinquished property.

Based upon the above, it is reasonable to conclude the IRS published the Revenue Ruling to rewrite the § 1031(f) law in the apparent hope that the courts will eventually adopt the two created, fallible, and unneeded rationales in a rule of law that invalidates nonrecognition treatment under (f)(4) if the related party ended up with cash or property not of like-kind.

III. TAX COURT OPINION

A. The Tax Court acknowledged the dispositive facts

The Tax Court acknowledged the dispositive facts for each transaction: the exchange agreement language that required the termination of the acquisition of the relinquished property as well as the exchange agreement itself if suitable replacement property were not found. App. 26a-29a.

Such exchange agreement language signified that Teruya from the outset had no right to cash or property not of like-kind, which meant Teruya as a matter of law merely continued its investments and did not anticipate the recognition gain on its relinquished properties. Reasons For Granting The Petition ("Reasons"), *supra* at I, II.A.

B. The Tax Court committed the logical fallacy of *ignoratio elenchi*

The Tax Court opinion conflicts with the disregarded *Coastal Terminals* case and the overlooked legislative purpose that accords nonrecognition treatment under § 1031(f). Reasons, *supra* at I. Accordingly, the opinion is imbued with the logical fallacy of *ignoratio elenchi*.

The court disregarded the Fourth Circuit precedent apparently upon the grounds that the case had "little relevance" here because, citing § 1031(f)(1)(B) (App. 37a), the court stated, § 1031(f) presupposes a related party exchange successfully satisfied the § 1031(a) continuity of investment requirement.

The Tax Court failed to apprehend that under § 1031(f), the "can be viewed as merely continuing his investment" question is the intended *second* and *narrow* § 1031 "test" that generally must be satisfied in order to preserve the nonrecognition treatment accorded upon passing the *first* and *broad* § 1031(a) "test." Reasons, *supra* at I.

Accordingly, *Coastal Terminals* is relevant here, and disregarding it contravenes the legislative intent manifested in the words, "can be viewed as merely continuing his investment."

C. The Tax Court committed the logical fallacy of affirming the consequent

The Tax Court correctly stated, "any inquiry into whether a transaction is structured to avoid the purposes of section 1031(f) should also take . . . [the

§ 1031(f)(2)(C)] exception into consideration." App. 34a-35a.

In doing so, the Tax Court inadvertently helped to clarify that applying the "related party ended up with cash" rationale commits the logical fallacy of affirming the consequent. Under the logical fallacy of affirming the consequent, the presence of an effect (*e.g.*, the related party ended up with cash) is incorrectly assumed to be sufficient evidence for a particular cause (*e.g.*, a (f)(1)(C) transaction), even though there is more than one possible cause (*e.g.*, a (f)(2)(C) or (f)(1)(A)(B) transaction) for the given effect. The following flawed line of reasoning demonstrates the logical fallacy of affirming the consequent:

1. If a (f)(1)(C) transaction is actually or in substance accomplished, the related party ends up with cash.
2. When a taxpayer accomplished his indirect related party exchange with the use of a QI, the related party ended up with cash.
3. Since the related party ended up with cash, the indirect related party exchange must be in substance a (f)(1)(C) transaction, and thus the taxpayer used the QI to circumvent (f)(1)(C), which means nonrecognition treatment should be invalidated under (f)(4).

Since a related party can end up with cash in a (f)(2)(C) transaction as well as in a (f)(1)(C) transaction, the fact that a related party ended up with cash is *not sufficient* reason to conclude the taxpayer used the QI to circumvent (f)(1)(C).

Alas, the Tax Court's analysis and conclusion is imbued with the logical fallacy of affirming the consequent as illustrated when the above flawed line of reasoning is compared with the following excerpts from the Tax Court opinion:

> These transactions are economically equivalent to direct exchanges of properties between Teruya and Times . . . followed by Times's sales of the properties to unrelated third parties. The interposition of a qualified intermediary in these transactions cannot obscure the *end result*. App. 35a.
>
> The economic substance of the transactions remains that the investments in Ocean Vista and Royal Towers were cashed out immediately and Times, *a related person, ended up with the cash proceeds*. App. 37a.
>
> We infer that the qualified intermediary was interposed in an attempt to *circumvent the section 1031(f)(1) limitations* that would have applied to exchanges directly between related persons. App. 38a-39a.
>
> (emphasis added.)

D. The Tax Court committed the logical fallacy of red herring and linked it to the logical fallacy of affirming the consequent

Finally, the Tax Court's conclusion contains a red herring: "Petitioner offers no explanation for Teruya's use of the qualified intermediary in the Ocean Vista and Royal Towers transactions." App. 38a. Why a transaction was planned, prearranged, or structured the way it was, is not a relevant § 1031(f) issue. Rather the *issue* is whether the transaction avoided the purposes of § 1031(f). Based upon the above, the issue is whether, as a matter of law, Teruya *merely* *continued its investments or anticipated the recognition of gains on its low basis relinquished properties.*

Furthermore, the Tax Court's red herring is linked to the Tax Court's logical fallacy of affirming the consequent by the sentence that follows the red herring: "We infer that the qualified intermediary was interposed in an attempt to circumvent the section 1031(f)(1) limitations that would have applied to exchanges directly between related persons." App. 38a-39a. Reasons, *supra* at III.C.

IV. NINTH CIRCUIT OPINION

A. The Ninth Circuit opinion directly conflicts with (1) the disregarded *Coastal Terminals*, (2) the ignored intended specific meaning of the acknowledged legislative purpose that accords nonrecognition treatment under § 1031(f), and (3) the legal precept that the substance of a transaction should prevail over its form

The Ninth Circuit's holding—that Teruya had "cashed out" of its investments "in contravention of Congress's desire that nonrecognition treatment only apply to transactions 'where a taxpayer can be viewed as merely continuing his investment'" (App. 15a-16a)—directly conflicted with the disregarded *Coastal Terminals* case, which addressed the "did not 'cash out' but merely continued taxpayer's investment" issue.

The holding also directly conflicted with the ignored intended specific meaning of the acknowledged legislative purpose that accords nonrecognition treatment under § 1031(f), generally only where a taxpayer *can be viewed* as merely continuing his investment. Reasons, *supra* at I.

The holding also directly conflicted with the overlooked application of the interdependence test of the Step Transaction Doctrine, which established that the Teruya transactions were in substance merely § 1031(f)(1)(A)(B) exchanges. Statement, supra at V.E.

Indeed, the Ninth Circuit's reliance upon the presumption a (f)(1)(C) disposition in substance occurred is not only inappropriate, but also a violation of settled law! Statement, *supra* at V.E.

The *entire* analysis and conclusion of the court are *necessarily irrelevant* since they rely upon the incorrect presumption a (f)(1)(C) disposition in substance occurred!

B. The Ninth Circuit's economic unit rationale is an *erroneous premise* and a manifestation of Commissioner's improper transformation of a legislative presumption into a legislative determination

The Ninth Circuit's analysis rests upon an *erroneous premise* that the related parties "should be treated as an economic unit" under (f)(4). Statement, *supra* at VI.

Simple logic shows such premise to be erroneous: Where a taxpayer did not "cash out" but merely continued his investment as a matter of law, *both* taxpayer and related party *cannot* have "cashed out" of the investment.

Furthermore, any analysis based upon such erroneous premise commits the logical fallacy of affirming the consequent similar to the one made by the Tax Court. *See* Reasons, *supra* at III.C-D.

Such logical fallacy becomes more evident after the Ninth Circuit correctly agreed with the lower court that (f)(2)(C) should be taken into account when applying (f)(4).

The economic unit rationale is a manifestation of Commissioner's improper transformation of a legislative presumption into a legislative determination in Revenue Ruling 2002-83. Reasons, *supra* at II.A-C.

C. The Ninth Circuit opinion conflicts with the controlling tax principle in a cited case and where this Court vacated a Ninth Circuit judgment

The two pillars upon which the Ninth Circuit conclusion rests—the QI rationale (App. 16.a) and the "advantageous tax consequences" rationale (App. 19a)—are contrary to the controlling tax principle in a case cited by the Ninth Circuit as an authority (App. 10a) and where this Court vacated a Ninth Circuit judgment: *Boulware v. United States*, 128 S. Ct. 1168, 1176 (2008), ("The question here, of course, is not whether alternative routes may have offered better or worse tax consequences . . . . [But] rather, it is 'whether what was done . . . was the thing which the statute . . . intended'").

The controlling tax principle in the *Boulware* decision turns the question back to the intended specific meaning of the legislative purpose that accords nonrecognition treatment under § 1031(f).

V. COMMISSIONER'S INTENT TO REWRITE THE LAW THROUGH THE COURTS APPEARS TO BE AN INTENT TO COMPROMISE THE INTEGRITY OF THE JURISPRUDENCE PROCESS

To repeat, Commissioner *ignored* the dispositive facts and, in doing so, *misleadingly* suggested that the Teruya transactions were like most other exchanges where taxpayers are legally obligated to sell the relinquished property for cash if suitable replacement property is not found. Statement, *supra* at V.C.

It appears that such subtle rewriting of the dispositive facts was deliberate. After all, the dispositive facts were jointly stipulated and acknowledged by the Tax Court (Statement, *supra* at III, IV).

Moreover, the government apparently *knew* that the requirement to terminate the dispositions of the relinquished properties was dispositive: In the *Ocmulgee* case the government refuted the taxpayer's non-tax avoidance argument by stating that such argument is "a *non sequitur*" and "essentially, meaningless. Nothing in . . . [Ocmulgee's] contract . . . for the sale of . . . [the relinquished property] *required* that the deal be structured as a likekind exchange." Page 58 of government's December 2, 2009 answering brief. Here by contrast, the requirements to terminate the dispositions of the relinquished properties signify that the relinquished properties were legally *required* to be exchanged or not disposed at all.

Since the Ninth Circuit overlooked the dispositive facts in a similar misleading way, Commissioner's rewriting appears to have influenced the court and thus compromised the integrity of the jurisprudence process.

Accordingly, it is reasonable to conclude that Commissioner's rewriting of the dispositive facts signifies that the intent behind Commissioner's attempt to rewrite the law through the courts was an intent to compromise the integrity of the jurisprudence process.

CONCLUSION

For these reasons, petitioner respectfully urges this Court to grant the petition for a writ of certiorari.

Respectfully submitted,

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APPENDIX

APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 05-73779
Tax Ct. No. 17955-03

TERUYA BROTHERS, LTD, and SUBSIDIARIES,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from a Decision of the Tax Court

Argued and Submitted
February 11, 2009—Honolulu, Hawaii
Filed September 8, 2009

Before: Stephen Reinhardt, Melvin Brunetti, and
Sidney R. Thomas, Circuit Judges.
Opinion by Judge Thomas

OPINION

THOMAS, *Circuit Judge*:

This case requires us to determine whether two like-kind exchanges involving related parties qualify for nonrecognition treatment under 26 U.S.C. § 1031. Under the circumstances presented by this case, we conclude that they do not, and we affirm the judgment of the Tax Court. We have jurisdiction over this appeal pursuant to 26 U.S.C. § 7482(a).[1]

I

Teruya Brothers, Ltd. ("Teruya") is a Hawaii corporation involved in, among other things, the purchase and development of residential and commercial real estate. This appeal concerns the tax treatment of real estate transactions involving two of Teruya's properties, the Ocean Vista condominium complex ("Ocean Vista"), and the Royal Towers Apartment building ("Royal Towers").

A

Teruya owned a fee simple interest in a parcel of land underlying the Ocean Vista complex in Honolulu, Hawaii. Golden Century Investments Company ("Golden") held a long-term lease on the land, and the Association of Apartment Owners of Ocean Vista ("the Association") held a sublease on the property.

In March 1993, the Association wrote to Teruya, inquiring about the possibility of purchasing Ocean Vista. Teruya responded that it was not interested in selling, though it later told Golden, which was also interested in the property, that it might part with the land through a like-kind exchange.

Following a series of negotiations, Golden sent a letter of intent to purchase Ocean Vista from Teruya for $1,468,500. It also offered its cooperation "so that Teruya can effectuate a [§] 1031 tax deferred exchange of Teruya's [i]nterests." The letter of intent was later amended to state, "It is understood and agreed that Teruya's obligation to sell Teruya's interests to [Golden] is conditioned upon Teruya consummating a [§] 1031 tax deferred exchange of Teruya's [i]nterests."

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[1] Except where otherwise noted, all statutory references are to the Internal Revenue Code.

In June 1994, Teruya proposed purchasing real property known as Kupuohi II from Times Super Market, Ltd. ("Times"), a company in which it owned 62.5% of the common shares. The proposal stated that "The purchase will be subject to a [§] 1031 four party exchange," and allowed Teruya to cancel the proposed purchase "should the Ocean Vista transaction fail to proceed according to present plans." Times agreed to sell Kupuohi II for $2,828,000.

On April 3, 1995, the Association made a formal offer to purchase Ocean Vista for $1,468,500,[2] which Teruya accepted. The parties' contract provided that "Teruya may, in its sole discretion, structure this transaction as a tax-deferred exchange pursuant to section 1031 of the Internal Revenue Code." The contract also included as a condition precedent to the sale that "Teruya shall be in a position to close on its exchange replacement properties."

In August, T.G. Exchange, Inc. ("TGE") contracted to act as an "exchange party to complete the exchange" of Ocean Vista. TGE would convey Ocean Vista to the Association, and then acquire replacement property for Teruya with the Ocean Vista sale proceeds, all with the stated purpose of qualifying the exchange under 26 U.S.C. § 1031. Teruya agreed to identify suitable replacement property, and to provide any funds in excess of the Ocean Vista sale proceeds needed to purchase the replacement property. The parties agreed that if Teruya could not locate suitable replacement property, the contract between Teruya and TGE would be terminated.

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[2] Teruya, Golden, and the Association had executed an Assignment, Assumption, and Release which substituted the Association for Golden.

On September 1, 1995, per the agreement, TGE sold Ocean Vista to the Association for $1,468,500. That same day, TGE used the proceeds from the Ocean Vista sale along with an additional $1,366,056 from Teruya to purchase Kupuohi II from Times for $2,828,000.[3] TGE then transferred Kupuohi II to Teruya.

Teruya's basis in Ocean Vista was $93,270, but it deferred recognizing gain on its $1,345,169 in post-expense profits under the like-kind exchange provisions of 26 U.S.C. § 1031. Times had a basis in Kupuohi II of $1,475, 361, and realized and recognized a $1,352,639 gain on the property's sale. Times paid no tax on this gain, however, because it had a large net operating loss for the tax year in question.

In sum, before the transaction Teruya owned Ocean Vista and Times owned Kupuohi II. After the exchange, Teruya owned Kupuohi II, the Association owned Ocean Vista, and Times had the cash from the sale of Ocean Vista (along with additional funds from Teruya).

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[3] As the Tax Court noted below, some of the numbers in the parties' stipulation of facts yield computational inconsistencies. Where the Tax Court made express findings as to the correct figures, we adopt and incorporate those determinations. As the precise numbers involved are not relevant to this appeal, we otherwise leave in place the parties' stipulated figures without further notation.

B

The Royal Towers exchange substantially mirrored the Ocean Vista transaction.

In 1994 Teruya owned a fee simple interest in Royal Towers, an apartment complex in Honolulu, Hawaii. Late that year, Teruya agreed to sell Royal Towers to Savio Development Company ("Savio") for $13.5 million (later negotiated down to $11,932,000). As with the Ocean Vista transaction, this agreement was expressly conditioned on Teruya successfully completing a § 1031 exchange.

Anticipating that Royal Towers would soon be sold, in September 1994 Teruya sent Times a letter of intent to purchase two pieces of land known respectively as Kupuohi I and Kaahumanu. The letter was materially identical to the one Teruya sent to Times regarding Kupuohi II, and stated that "[t]he purchase will be subject to a [§] 1031 four party exchange," and that Teruya could cancel the proposed purchase "should the sale of the Royal Towers apartment fail to proceed according to present plans." Both companies' boards of directors approved the two properties' sale in early 1995, with Kupuohi I to be sold for $8,900,000, and Kaahumanu for $3,730,000.

In August 1995, Teruya contracted with TGE in order to qualify the exchange under § 1031. Similar to its agreement concerning the Ocean Vista exchange (which would be signed two days later), TGE would convey Royal Towers to Saito, acquiring replacement property for Teruya with the Royal Tower sale proceeds. Teruya agreed to identify suitable replacement property, and to provide any funds in excess of the Royal Towers sale proceeds needed to purchase the replacement property. The parties agreed that if Teruya could not locate suitable replacement property, the agreement between Teruya and TGE would be terminated.

TGE sold Royal Towers to Saito on August 24, 1995 for $11,932,000. Also on August 24, TGE used the proceeds from the Royal Towers sale along with $724,554 in additional funds from Teruya to purchase Kupuohi I and Kaahumanu from Times for $8,900,000 and $3,730,000, respectively. TGE then transferred the two properties to Teruya.

Teruya's basis in Royal Towers was $670,506, but it deferred the recognition of its $10,700,878 in post-expenses profits under 26 U.S.C. § 1031. Times had a basis in Kaahumanu of $1,502,960, and realized and recognized a $2,227,040 gain on the property's sale. Just as with Kupuohi II, though, Times paid no tax on this gain because it had a large net operating loss for the tax year in question.

Times had a basis in Kupuohi I of $15,602,152, and realized a capital loss of $6,453,372 on its sale. It did not recognize this loss, however, because 26 U.S.C. § 267 prohibits the recognition of losses from sales and exchanges of property between "related parties."[4]

In sum, before the exchanges Teruya owned Royal Towers and Times owned Kupuohi I and Kaahumanu. Afterwards, Teruya owned Kupuohi I and Kaahumanu, Savio owned Royal Towers, and Times held the cash from the sale of Royal Towers to Savio (along with additional funds from Teruya).

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[4] The definition of "related person" is drawn from 26 U.S.C. §§ 267(b) and 707(b)(1), and includes, *inter alia*, family members, partnerships, and entities over which the taxpayer has control (or which control the tax-payer). *See* 26 U.S.C. § 1031(f)(3). Teruya has stipulated that at all times relevant to this litigation it and Times were "related parties."

C

On its corporate income tax return for the taxable year ending March 31, 1996, Teruya, pursuant to 26 U.S.C. § 1031, deferred gain of $1,345,169 from the Ocean Vista transaction, and $10,700,878 from the Royal Towers transaction.

Rejecting Teruya's treatment of the exchanges, the IRS issued Teruya a notice of deficiency of $4,144,359 for the tax year ending March 31, 1996. Teruya petitioned the Tax Court for a redetermination. The Tax Court considered the petition on the basis of stipulated facts, and it affirmed the IRS's nonrecognition treatment in a published opinion. *See Teruya Bros., Ltd. & Subsidiaries v. Comm'r of Internal Revenue*, 124 T.C. 45 (2005). This timely appeal followed.

II

26 U. S.C. § 1031(a)(1) is a well-worn exception to the general rule that taxpayers must recognize gains or losses realized from the disposition of property in the year of realization. *See* 26 U.S.C. § 1001(c). Rather, in a so-called "section 1031" exchange, gain realized on the exchange of like-kind property held for productive business use or investment need not be recognized until the acquired property is finally disposed of. To preserve the appropriate tax consequences, the taxpayer retains his original basis in the newly acquired property. *Id.* at § 1031(d).

The concept behind this exception derives from the assumption that when an investor exchanges a piece of property for another of like-kind, he is merely continuing an ongoing investment, rather than ridding himself of one investment to obtain another. *See Starker v. United States*, 602 F.2d 1341, 1352 (9th Cir. 1979) ("The legislative history [of § 1031] reveals that the provision was designed to avoid the imposition of a tax on those who do not 'cash in' on their investments in trade or business property."). "In effect, the nonrecognition provisions further defer tax consequences when, notwithstanding an exchange, the taxpayer maintains a continuing interest in similar property." 2 Boris Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, (3d ed. 2000), 44.1.1.

Before 1989, taxpayers acting in concert could lawfully use § 1031 to defer the recognition of gain or accelerate the recognition of loss even as they cashed out of their investments, as indicated by the following example:

> [A]ssume *T* owns Blackacre, which is worth $100 and has a basis of $20, and her wholly owned corporation, *C* Corp., owns like kind property (Whiteacre), which is also worth $100 but has a basis of $140; *T* and *C* swap, and *C* immediately sells Blackacre to an unrelated person. If *T* had sold Blackacre, she would have recognized gain of $80, but C, whose $140 basis for Whiteacre becomes its basis for Blackacre, recognizes loss of $40. . . . [T]he presale exchange . . . [has] the effect of deferring recognition of *T*'s potential gain and accelerating recognition of *C*'s $40 loss.

Id. 44.2.8.

[1] Congress enacted § 1031(f) in 1989, largely eliminating what it considered to be a tax loophole contained in the section. *See* Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7601, 103 Stat. 2106 (1989). Section 1031(f)(1) largely precludes the nonrecognition treatment of gain or loss when a taxpayer exchanges like-kind

property with a related person, and when either party then disposes of the exchanged property within two years.[5]

Congress also included § 1031(f)(4), which provides that a taxpayer may not claim nonrecognition treatment under § 1031 for "any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of [§ 1031(f)]."

Section 1031(f) includes several exceptions, as well. As relevant here, exchanges that otherwise run afoul of § 1031(f)(1)'s requirements may still qualify for nonrecognition treatment where "it is established to the satisfaction of the Secretary that neither the exchange nor [the subsequent property] disposition had as one of its principal purposes the avoidance of Federal income tax." § 1031(f)(2)(C).[6]

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[5] The subsection reads, in full:

> § 1031(f). Special rules for exchanges between related persons.
>
> (1) In general. If—
>
> (A) a taxpayer exchanges property with a related person,
>
> (B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and
>
> (C) before the date 2 years after the date of the last transfer which was part of such exchange—
>
> i) the related person disposes of such property, or
>
> (ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

III

A

We review the Tax Court's conclusions of law and interpretations of the tax code *de novo*. *Westpac Pac. Food v. Comm'r of Internal Revenue*, 451 F.3d 970, 974 (9th Cir. 2006). We review the Tax Court's factual findings, including factual inferences drawn from a stipulated record, for clear error. *Smith v. Comm'r of Internal Revenue*, 300 F.3d 1023, 1028 (9th Cir. 2002).

[2] In conducting our analysis, we are mindful of the fact that tax classifications "turn on 'the objective economic realities of a transaction rather than . . . the particular form the parties employed.'" *Boulware v. United States*, 128 S. Ct. 1168, 1175 (2008) (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978)). Exceptions to the general rule requiring the recognition of all gains and losses on property dispositions are to be "strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception." 26 CFR 1.1002-1(b). Thus, "[n]onrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted

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[6] Nonrecognition treatment is also accorded to otherwise improper like-kind exchanges where the property is disposed of after the taxpayer's or related party's death, or in a compulsory or involuntary conversion. *See* § 1031(f)(2)(A)-(B).

exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule." *Id.*[7]

B

[3] As an initial matter, the government quite properly concedes that the Ocean Vista and Royal Towers transactions both qualify as like-kind exchanges under § 1031(a)(1). Indeed, although significantly more complex than "traditional" two-party transactions, four-party like-kind exchanges like those utilized here have existed for nearly as long as the § 1031 exception itself. *See, e.g., Mercantile Trust Co. v. Comm'r of Internal Revenue*, 32 B.T.A. 82 (1935). The Tax Court has succinctly described such exchanges' general form:

> Involved in this type of exchange is a taxpayer desiring to exchange property, a prospective purchaser of the taxpayer's property, a prospective seller of the property the taxpayer wishes to receive in exchange, and a fourth party. In a simultaneously executed transaction (usually done through escrow) the fourth party receives the taxpayer's property and sells that property to the prospective purchaser. With the funds he receives, he purchases the prospective seller's property and then transfers that property to the taxpayer. When the smoke has cleared, the taxpayer has exchanged his property in a so-called 1031 transaction, the prospective purchaser has the taxpayer's property, the prospective

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[7] The examination in this case began before the July 22, 1998 effective date of 26 U.S.C. § 7491, so that section's burden-shifting rules do not apply here. *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub L. No. 105-206, Title III, § 3001(a), 112 Stat. 685, 726-27 (1998).

> seller has cash, and the fourth party, with the exception of agreed compensation, nothing.

Coupe v. Comm'r of Internal Revenue, 52 T.C. 394, 405 (1969) (citing *Mercantile Trust*, 32 B.T.A. 82). Applying this framework to our case, Teruya is the taxpayer, Times the prospective seller, the Association and Saito each prospective purchasers, and TGE the "fourth party," or qualified intermediary.[8]

The government also does not argue that § 1031(f)(1)'s restrictions on direct exchanges between related parties encompass these indirect transactions. For like-kind exchanges conducted through a qualified intermediary, as these were, "the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a)." 26 C.F.R. § 1.1031(k)-1(g)(4)(i). Teruya, therefore, may be said to have exchanged properties with TGE, not "with a related person," as required to implicate § 1031(f)(1).

[4] Thus, these exchanges may only be denied nonrecognition treatment if they were "part of a transaction (or series of transactions) structured to avoid the purposes of [§ 1031(f)]." § 1031(f)(4).

The first step in determining whether these transactions were structured to avoid § 1031(f)'s purposes is, of course, identifying what those purposes are. To discern a statute's purposes, "we look first to the language of the statute and second to its legislative history." *In re Stringer*, 847 F.2d 549, 551 (9th Cir. 1988). In this case, though, the statute's text provides precious few clues as to Congress's intent. Section 1031(f)'s existence alone tells us that Congress wanted to limit the ability of related parties to claim nonrecognition treatment for § 1031 exchanges. But, given that Teruya's exchanges are not expressly covered under § 1031(f)(1), it would beg the question to conclude from the statute's text alone that Congress wanted to deny these transactions nonrecognition treatment.

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[8] A qualified intermediary is a person, not the taxpayer or one closely related to him, who "[e]nters into a written agreement with the taxpayer . . . and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." 26 C.F.R. § 1.1031(k)-1(g)(4)(iii).

Accordingly, we turn to § 1031(f)'s legislative history.

[5] The House Report accompanying § 1031(f) establishes that one of Congress's primary concerns in passing this legislation was its belief "that the 'like-kind' standard as applied to exchanges of property [wa]s too broad." H.R. Rep. No. 101-247, pt. 6, at 1340 (1989). "Under present law, taxpayers have been granted nonrecognition treatment . . . in circumstances where they have significantly changed their investment as a result of the exchange or conversion." *Id.* Instead, the committee felt "it is appropriate to accord nonrecognition treatment only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment." *Id.*

[6] Congress also wanted to prevent related parties from taking advantage of § 1031(d)'s basis-shifting provisions to avoid gains or accelerate losses on cashed-out investments. The House committee wrote:

> Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipa-

> tion of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment.

Id.

Finally, the House committee offered an example of a transaction it intended § 1031(f)(4) to cover:

> [I]f a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.

Id. at 1341.

C

[7] With this legislative background in mind, we conclude that the Tax Court did not err in determining that the transactions were structured to avoid the purposes of § 1031(f)(4). Under the guise of a like-kind exchange, the transactions allowed related parties to receive nonrecognition treatment while cashing out of investments using § 1031's basis-shifting provisions. Precluding this type of tax result was one of Congress's primary aims in enacting § 1031(f)(4).

[8] We first reject Teruya's contention that the economic consequences of these transactions to Times are irrelevant to our inquiry, and that Teruya's continued investment in real property is dispositive. Section 1031(f)(1)(C)(i) disallows nonrecognition treatment if the related party disposes of exchanged property within two years, regardless of whether the taxpayer does as well. Thus, examining the taxpayer and related party's economic position in aggregate is often the only way to tell if § 1031(f) applies. Moreover, Congress's concern about related taxpayers acting in concert, as well as the House Report's admonition that exchanges should not be accorded nonrecognition treatment where "the related *parties* have, in effect, 'cashed out' of" the investment," H.R. Rep. No. 101-247, pt. 6, at 1340 (emphasis added), confirm that the taxpayer and the related party should be treated as an economic unit in this inquiry. Taxpayers cannot escape § 1031(f) simply by hiding the benefits of improper like-kind exchanges with a related party.

[9] Here, the changing economic positions of Teruya and Times readily show that the related parties used these exchanges to cash out of an investment in low-basis real property. Before the exchanges, Teruya owned Ocean Vista and Royal Towers, and Times owned Kupuohi I, Kupuohi II, and Kaahumanu. After the exchanges, Ocean Vista and Royal Towers had been sold, Teruya owned Kupuohi I, Kupuohi II, and Kaahumanu, and Times now had the cash from the Ocean Vista and Royal Towers sale (along with boot from Teruya). All in all, Teruya and Times decreased their investment in real property by approximately $13.4 million, and increased their cash position by the same amount. By allowing Teruya and Times to cash out of a signifi-

cant investment in real property under the guise of a non-taxable like-kind exchange, these transactions were undoubtedly structured in contravention of Congress's desire that nonrecognition treatment only apply to transactions "where a taxpayer can be viewed as merely continuing his investment." *See* H.R. Rep. No. 101-247, pt. 6, at 1340.

Indeed, as Teruya could have achieved the same property dispositions through far simpler means, it appears that these transactions took their peculiar structure for no purpose except to avoid § 1031(f). Teruya could have exchanged its properties directly with Times, followed by Times selling Ocean Vista and Royal Towers to the third-party purchasers. There was no need to use (and pay) a qualified intermediary. The rub, of course, is that Teruya couldn't have done this tax free, as direct exchanges between related parties are ineligible for nonrecognition treatment when the exchanged property is sold within two years. Instead, Teruya employed TGE, whose presence ensured that Teruya was technically exchanging properties with the qualified intermediary, not with its related party. TGE's involvement in these transactions thus served no purpose besides rendering simple—but tax disadvantageous—transactions more complex in order to avoid § 1031(f)'s restrictions.[9]

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[9] We do not imply that taxpayers are precluded from using a qualified intermediary to facilitate a like-kind exchange with a related party. Qualified intermediaries may provide legitimate services to facilitate complex (but permissible) exchanges, such as by assisting with escrow. However, given the facts of this case, we conclude that the Tax Court did not clearly err in inferring that the qualified intermediary was interposed in this case in an attempt to circumvent the § 1031(f)(1) limitations. The

Our initial conclusion that these transactions were structured to avoid § 1031(f)'s purposes does not end our inquiry, for Teruya argues, and the Tax Court held below, that § 1031(f)(2) provides an additional limitation on § 1031(f)(4)'s scope.

[10] As discussed previously, § 1031(f)(2) establishes several circumstances where a related party exchange may still qualify for nonrecognition treatment despite technically violating § 1031(f)(1). The broadest of these exceptions, § 103 1 (f)(2)(C), allows otherwise improper exchanges to earn nonrecognition treatment where "it is established to the satisfaction of the Secretary that neither the exchange nor [the subsequent] disposition had as one of its principal purposes the avoidance of Federal income tax."[10]

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government argues that every deferred exchange between related parties involving a qualified intermediary should be recast as a direct exchange between the related parties. Under that analysis, the government argues, if § 1031(f)(1) would preclude nonrecognition treatment for the recast transaction, then the deferred exchange should be deemed to have been structured to avoid the purposes of § 1031(f). The Tax Court properly rejected that mechanical theory as inconsistent with the structure of the statute.

[10] The subsection reads:

> § 1031(f). Special rules for exchanges between related persons. . . .
>
> (2) Certain dispositions not taken into account. For purposes of paragraph (1)(C), there shall not be taken into account any disposition—
>
> (A) after the earlier of the death of the taxpayer or the death of the related person,
>
> (B) in a compulsory or involuntary conversion . . . if the exchange occurred before the threat or imminence of such conversion, or

[11] By their plain language, § 1031(f)(2)'s exceptions only apply to exchanges that violate § 1031(f)(1), which, as discussed above, these exchanges do not. Still, the Tax Court held below that "[b]ecause [§ 1031(f)(2)] is subsumed within the purposes of § 1031(f), any inquiry into whether a transaction is structured to avoid the purposes of section 1031(f) should also take this exception into consideration." *Teruya Brothers*, 124 T.C. at 53. We agree. Section 1031(f)(4) denies nonrecognition treatment only to those transactions that violate § 1031(f)(1)'s purposes. As transactions falling within § 1031(f)(2)'s exceptions by their very nature do not violate those purposes, § 1031(f)(2) must independently limit § 1031(f)(4)'s scope. In other words, a transaction does not violate § 1031(f)(4) if the taxpayer can establish "to the satisfaction of the Secretary" that the transaction did not have "as one of its principal purposes the avoidance of Federal income tax."

[12] Despite our determination that § 1031(f)(2) independently limits § 1031(f)(4), we conclude that the record supports the Tax Court's determination that the improper avoidance of federal income tax was one of the principal purposes behind these exchanges. We therefore affirm the Tax Court's denial of nonrecognition treatment to Teruya.[11]

> (C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

[11] In other contexts involving similar language, courts have disagreed on the standard to apply in reviewing whether a taxpayer has established a fact "to the satisfaction of the Secretary." *Compare R.E. Dietz Corp. v. United States*, 939 F.2d 1, 5 (2d Cir. 1991) (applying arbitrary and capricious standard), with

The Tax Court's conclusion that these transactions were structured for unwarranted tax avoidance purposes is sup-ported by an examination of the tax consequences of the Royal Towers exchange. Had Teruya sold Royal Towers directly to Saito, it would have had to recognize nearly $11 million in gain. Because the transaction was presented as a like-kind exchange, however, only Times, which sold Kupuohi I and Kaahumanu to TGE, had to recognize any profit. However, Kaahumanu had a much higher basis than Royal Towers (relative to its fair market value), and Kupuohi I's basis far exceeded its fair market value. Thus, Times recognized only $2.2 million in gain on the transaction, far less than Teruya would have faced from the direct sale of Royal Towers. Moreover, Times paid no tax on even this smaller gain, as it was able to carry over net operating losses from previous years. Similarly, in the Ocean Vista transaction, though Times recognized gain virtually identical to that which Teruya deferred, Times paid no tax due to its net operating losses. Thus, the Teruya/Times economic unit achieved far more advantageous tax consequences by employing this unique structure than it would have had Teruya simply sold its properties to the third-party buyers itself.[12]

Schoneberger v. Comm'r of Internal Revenue, 74 T.C. 1016, 1024 (1980) (applying "strong proof" standard). We need not decide the appropriate standard to apply, nor do we interpret the precise contours in this context of the phrase "to the satisfaction of the Secretary."

[12] Theoretically, the tax price to Times from reducing its net operating losses may have equaled or even exceeded the tax Teruya deferred, particularly in the Ocean Vista transaction. *See generally* Kelly Alton *et al.*, *Related-Party Like-Kind Exchanges*, 115 TAX NOTES 467, at *26-27 (2007). We need not determine whether this possibility would evince a non-tax

Teruya contends that it did not have an improper tax avoidance purpose because it never had any fixed right to cash at the time of these transactions; indeed, the exchanges could only have been completed as § 1031(a) like-kind exchanges. But this argument misses the point. Teruya's undisputed intent to complete successfully a like-kind exchange—perhaps germane to whether the transactions were exchanges or sales under § 1031(a)—is irrelevant to whether these trans-actions were structured to avoid § 1031(f)'s purposes. Moreover, by focusing only on its own continued investment in like-kind property, Teruya ignores the crucial tax consequences of these exchanges to its related party, Times.[13]

IV

[13] For the aforementioned reasons, we affirm the Tax Court's determination that these exchanges were structured to avoid the purposes of § 1031(f), and thus violate § 1031(f)(4).

AFFIRMED.

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avoidance purpose, as Teruya has not argued the point on appeal.

[13] The Conference Committee Report to § 1031(f) suggests several kinds of transactions between related parties that "generally" will not have unwarranted tax avoidance as a principal purpose, such as exchanges that do not involve basis shifting. *See* 101 H.R. Conf. Rep. No. 386, at 614. Teruya has not argued that its exchanges fall within these exceptions.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[Filed Nov. 9, 2009]

No. 05-73779
Tax Ct. No. 17955-03

TERUYA BROTHERS, LTD, and SUBSIDIARIES,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

ORDER

Before: REINHARDT, BRUNETTI and THOMAS, *Circuit Judges*.

The panel has voted to deny the petition for rehearing and to reject the petition for rehearing en banc.

The full court has been advised of the petition for rehearing en banc, and no judge of the court has requested a vote on the petition for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing and the petition for rehearing en banc are rejected.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

[Filed Nov. 17, 2009]

No. 05-73779
Tax Ct. No. 17955-03

TERUYA BROTHERS, LTD, and SUBSIDIARIES,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

ORDER

Before: REINHARDT, BRUNETTI and THOMAS, *Circuit Judges.*

Appellant's motion for stay of mandate is granted. Issuance of the mandate shall be stayed for thirty (30) days. If Appellant has not filed a petition for certiorari within the thirty (30) day period, the mandate shall issue forthwith.

APPENDIX D

UNITED STATES TAX COURT
124 T.C. No. 4

Docket No. 17955-03

TERUYA BROTHERS, LTD, & SUBSIDIARIES,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Filed February 9, 2005

In 1995, in a series of planned transactions, P transferred real properties to a qualified intermediary, TGE, which then sold them to unrelated third parties. TGE used the sale proceeds, as well as additional funds from P, to purchase like-kind replacement properties for P from a corporation related to P.

Held: The transactions in question were structured to avoid the purposes of sec. 1031(f), I.R.C., governing like-kind exchanges between related persons. Under sec. 1031(f)(4), I.R.C., P is not entitled to defer gains realized on the exchanges.

Jonathan H. Steiner, William E. Bonano, and Stanley Y. Mukai, for petitioner.

Jonathan J. Ono, for respondent.

OPINION

THORNTON, *Judge*: Respondent determined a $4,144,359 deficiency in petitioner's Federal income tax for its taxable year ending March 31, 1996. The issue for decision is whether petitioner is entitled to defer gains realized on certain like-kind exchanges under section 1031(a) or must recognize gains under section 1031(f), which provides special rules governing exchanges between related persons.[1]

Background

This case is before us fully stipulated pursuant to Rule 122. We incorporate herein the stipulated facts. When petitioner filed its petition, its principal place of business was in Honolulu, Hawaii.

Teruya Brothers, Ltd. (Teruya), is a Hawaii corporation. Its business activities include purchasing and developing residential and commercial real property. During the taxable year in issue, Teruya owned 62.5 percent of the common shares of Times Super Market, Ltd. (Times).

I. Exchanges of Properties

In 1995, Teruya engaged in two separate real property exchange transactions, referred to herein as the Ocean Vista transaction and the Royal Towers transaction.

A. Ocean Vista Transaction

Teruya owned a fee simple interest in Ocean Vista, a parcel of land underlying the Ocean Vista Condominium complex in Honolulu, Hawaii. Teruya's ownership interest in Ocean Vista was subject to a long-term ground lease held by Golden Century Investments Co. (Golden), which in turn was subject to a sublease held by the Association of Apartment Owners of Ocean Vista (the Association).

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[1] Section references are to the Internal Revenue Code in effect for the taxable year in issue and as amended. Rule references are to the Tax Court Rules of Practice and Procedure.

In March 1993, the Association inquired about buying Teruya's fee simple interest in Ocean Vista. Teruya responded that its fee simple interest in Ocean Vista was not available. Golden then proposed acquiring Ocean Vista as part of a like-kind exchange. In a letter of intent agreement, dated August 16, 1993, Golden agreed to purchase, and Teruya agreed to sell, Teruya's interest in Ocean Vista for $1,468,500. An amendment to the letter of intent, dated November 2, 1993, states: "It is understood and agreed that Teruya's obligation to sell Teruya's Interests to * * * [Golden] is conditioned upon Teruya consummating a [section] 1031 tax deferred exchange of Teruya's interests."

In June 1994, Teruya proposed buying Times's interest in "two pad sites" in Waipahu, Hawaii (these properties are hereinafter referred to collectively as Kupuohi II). Teruya's written proposal included these provisions:

> The purchase will be subject to a [section] 1031 four party exchange.
>
> Teruya may cancel the proposed purchase of * * * [Times's] pad sites should the Ocean Vista transaction fail to proceed according to present plans.

Times accepted Teruya's proposal.

In a letter to Teruya and Golden, dated April 3, 1995, the Association offered to purchase Teruya's fee simple interest in Ocean Vista for $1,468,500.[2] Paragraph 9 of the offer to purchase states:

> Tax-deferred Exchange. Teruya may, in its sole discretion, structure this transaction as a tax-deferred exchange pursuant to section 1031 of the Internal Revenue Code.

Paragraph 12 of the offer to purchase states:

> Conditions Precedent. The following shall be conditions precedent to the closing of the transaction contemplated hereunder: * * *
>
> > (h) Teruya shall be in a position to close on its exchange replacement properties.

On April 27, 1995, Teruya's board of directors accepted the Association's offer.

In August 1995, Teruya entered into an "exchange agreement" with T.G. Exchange, Inc. (TGE), whereby TGE agreed to act as an "exchange party to complete the exchange" of Ocean Vista for replacement property to be designated by Teruya, with the stated purpose of qualifying the exchange under section 1031. TGE agreed to acquire the replacement property with proceeds from the sale of Ocean Vista and additional funds from Teruya as necessary to effect the acquisition. Paragraph 6 of the exchange agreement states:

> Notwithstanding the foregoing, if * * * [Teruya] is unable to locate suitable Replacement Property by the date specified in the Acquisition Agreement [for Ocean Vista], then the Acquisi-

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[2] On June 14, 1994, Teruya, Golden, and the Association executed an "Assignment, Assumption and Release", wherein the Association was substituted as a party in place of Golden.

> tion Agreement and this Exchange Agreement shall be terminated and the parties shall have no further obligations to each other * * *.

Pursuant to the exchange agreement, Teruya transferred Ocean Vista to TGE, and on September 1, 1995, TGE sold Ocean Vista to the Association for $1,468,500. At that time, Teruya had a $93,270 basis in Ocean Vista.

Also on September 1, 1995, TGE applied the proceeds from the sale of Ocean Vista, as well as $1,366,056 in additional cash from Teruya, to acquire Kupuohi II from Times for $2,828,000. Times had a $1,475,361 adjusted basis in Kupuohi II and recognized a $1,352,639 gain on the sale.[3]

At some point, TGE transferred Kupuohi II to Teruya. As of the date the petition was filed, Teruya still owned Kupuohi II.

B. Royal Towers Transaction

In 1994, Teruya owned a fee simple interest in the Royal Towers Apartment building (Royal Towers) in Honolulu, Hawaii. On or about December 12, 1994, Teruya and Savio Development Co. (Savio) entered into a $13.5 million contract for the sale of Royal Towers. The contract stated that the sale was subject to the "Seller [Teruya] being able to consummate [a section 1031] exchange." Teruya and Savio later agreed to decrease the price for Royal Towers from

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[3] The parties have stipulated that Times had a $1,475,633 basis in Kupuohi II at the time of its sale; however, this number yields computational inconsistencies with respect to other numerical stipulations. To avoid these inconsistencies, we have found Times's adjusted basis in Kupuohi II to be $1,475,361, which is the number reflected on Times's 1995 corporate income tax return.

$13.5 million to $11,932,000. In April 1995, Teruya's board of directors approved the sale of Royal Towers to Savio.

In anticipation of Teruya's sale of Royal Towers, Teruya and Times previously had agreed that Teruya would purchase Times's interests in two parcels of real property in Waipahu and Aiea, Hawaii (respectively, Kupuohi I and Kaahumanu). One of the purchase terms stated:

> The purchase will be subject to a [section] 1031 four party exchange.
>
> * * * *
>
> Teruya may cancel the proposed purchase should the sale of the Royal Towers apartment fail to proceed according to present plans.

Early in 1995, the boards of directors of Times and Teruya approved the sale and purchase of Kupuohi I for $8.9 million and Kaahumanu for $3.73 million.

In August 1995, Teruya entered into an "exchange agreement" with TGE, whereby TGE agreed to act as an "exchange party to complete the exchange" of Royal Towers for replacement property to be designated by Teruya, with the stated purpose of qualifying the exchange under section 1031. TGE agreed to acquire the replacement property with proceeds from the sale of Royal Towers and additional funds from Teruya as necessary to effect the acquisition. Paragraph 6 of the exchange agreement states:

> Notwithstanding the foregoing, if * * * [Teruya] is unable to locate suitable Replacement Property by the date specified in the Acquisition Agreement [for Royal Towers], then the Acquisition Agreement and this Exchange Agreement

> shall be terminated and the parties shall have no further obligations to each other * * *.

Teruya transferred Royal Towers to TGE, and on August 24, 1995, TGE sold Royal Towers to Savio for $11,932,000. At that time, Teruya had a $670,506 basis in Royal Towers.

Also, on August 24, 1995, TGE applied the proceeds from the sale of Royal Towers, as well as $724,554 in additional funds from Teruya, to acquire Kupuohi I and Kaahumanu from Times for $8.9 million and $3.73 million, respectively.[4] At the time of the sales, Times had a $15,602,152 adjusted basis in Kupuohi I and a $1,502,960 adjusted basis in Kaahumanu. Times realized a $6,453,372 capital loss on the sale of Kupuohi I but did not recognize this loss on its tax return because of the restriction on transactions between related taxpayers under section 267.[5] Times realized and recognized a $2,227,040 gain on the sale of Kaahumanu.

At some point, TGE transferred Kupuohi I and Kaahumanu to Teruya. As of the date the petition was filed, Teruya still owned these properties.

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[4] The proceeds from the sale of Royal Towers ($11,932,000) and the additional funds from Teruya ($724,554) total $12,656,554. The agreed sale price for Kupuohi I ($8.9 million) and Kaahumanu ($3.73 million), however, totaled $12,630,000. The parties do not explain this seeming discrepancy.

[5] The parties stipulated the $6,453,372 realized capital loss on the sale of Kupuohi I; however, on the basis of the $8.9 million sale price and the $15,602,152 adjusted basis that the parties stipulated, it appears that the loss realized was actually $6,702,152. The parties do not address this seeming discrepancy.

II. Federal Income Tax Return

Petitioner filed Form 1120, U.S. Corporation Income Tax Return, for its taxable year beginning April 1, 1995, and ending March 31, 1996. Under section 1031(a)(1), petitioner deferred $1,345,169 in realized gain from the Ocean Vista transaction (after deducting claimed selling expenses of $30,061) and $10,700,878 in realized gain from the Royal Towers transaction (after deducting claimed selling expenses of $560,616).

III. Notice of Deficiency

In the notice of deficiency, respondent determined that petitioner must recognize $12,041,026 in gains, which consists of the gains that Teruya deferred on its Federal income tax return for its taxable year ending March 31, 1996.[6]

Discussion

This case presents an issue of first impression regarding the application of section 1031(f), which restricts nonrecognition of gain or loss with respect to like-kind exchanges between related persons.[7]

I. General Requirements for Like-Kind Exchanges

Section 1031(a)(1) generally provides that no gain or loss shall be recognized on the exchange of like-kind properties held for productive use in a trade or business or for investment. Under certain conditions, a taxpayer's nonsimultaneous transfer and receipt of like-kind properties may qualify for section 1031 treatment, provided generally that the taxpayer identifies the new property within 45 days and receives it within 180 days of transferring the old property. See sec. 1031(a)(3). To facilitate such a deferred exchange, the taxpayer may use a qualified intermediary; i.e., a person who is not the taxpayer, an agent of the taxpayer, a related person to the taxpayer, or a related person to an agent of the taxpayer, see sec. 1.1031(k)-1(k), Income Tax Regs., who enters into a written exchange agreement with the taxpayer and, as required by this agreement, acquires property from the taxpayer, transfers this property, acquires like-kind replacement property, and transfers this replacement property to the taxpayer. Sec. 1.1031(k)-1(g)(4)(iii), Income Tax Regs.

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[6] The deferred gains from the Ocean Vista and Royal Towers transactions that the parties stipulated total $12,046,047. The parties do not explain the seeming discrepancy between this figure and the $12,041,026 adjustment in the notice of deficiency.

[7] The examination in this case commenced in November 1997. Consequently, the burden of proof rule of sec. 7491(a)(1) does not apply. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, sec. 3001(c), 112 Stat. 727.

Teruya used a qualified intermediary, TGE, to facilitate its transfers of Ocean Vista and Royal Towers and its acquisitions of Kupuohi II, Kupuohi I, and Kaahumanu. Respondent does not dispute that these transactions meet the general requirements for like-kind exchanges under section 1031(a)(1). Respondent contends, however, that section 1031(f) requires petitioner to recognize gains on the transactions.

II. Rules Applicable to Related-Person Exchanges

Section 1031(f)(1) provides generally that if a taxpayer and a related person exchange like-kind property and within 2 years either one disposes of the exchanged property, the nonrecognition provisions of section 1031(a) do not apply. Instead, any gain or loss must be taken into account as of the date of the disposition. As one of the few enumerated exceptions to this rule, section 1031(f)(2)(C) provides that a disposition of exchanged property will not be taken into account if "it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax."[8]

It is undisputed that Times and Teruya were related persons within the meaning of the statute.[9] Respondent makes no argument, however, that section 1031(f)(1) applies directly to the Ocean Vista and Royal Towers transactions.[10] Instead, respondent argues that petitioner has run afoul of section 1031(f)(4), which provides: "This section [1031] shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection [(f)]." Inasmuch as the statute does not directly identify or describe the purposes of subsection (f), we turn our attention to the legislative history.

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[8] Other exceptions, not implicated here, apply to dispositions after the death of the taxpayer or related party, see sec. 1031(f)(2)(A), and to involuntary conversions, see sec. 1031(f)(2)(B).

[9] A related person is any person bearing a relationship to the taxpayer described in sec. 267(b) or 707(b)(1). Sec. 1031(f)(3).

[10] Respondent appears to acknowledge implicitly that sec. 1031(f)(1) applies only in the case of a direct exchange between related persons and that this case does not involve such a direct exchange. Consistent with such a view, the regulations provide that a "qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a)." Sec. 1.1031(k)-1(g)(4)(i), Income Tax Regs.

III. Legislative History: Purposes of Section 1031(f)

Property acquired in a like-kind exchange generally takes the basis of the property relinquished. See sec. 1031(d). In other words, there is a "shifting" of tax basis between the relinquished property and the replacement property. See H. Conf. Rept. 101-386, at 613 (1989).

Before 1989, Congress was concerned that because of this basis-shifting effect, "related parties * * * engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale." H. Rept. 101-247, at 1340 (1989). In effect, because of basis shifting, related persons were able to "cash out" of their investments in property having an inherent gain at relatively little or no tax cost. See *id.* Also, in some cases, basis shifting allowed related persons to accelerate a loss on property that they ultimately retained. See *id.* Responding to these perceived abuses, Congress concluded that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment." *Id.* This policy is reflected in section 1031(f), as enacted in the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, sec. 7601(a), 103 Stat. 2370.

Congress was also concerned that related persons not be able to circumvent the purposes of this rule by using an unrelated third party:

> Nonrecognition will not be accorded to any exchange which is part of a transaction or series

> of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. [H. Rept. 101-247, *supra* at 1341.]

Equating a qualified intermediary with the "unrelated party" referred to in the above-quoted example, respondent reads the example to mean that a deferred exchange between related parties, involving a qualified intermediary, should be recast as a direct exchange between the related parties. If section 1031(f)(1) would preclude nonrecognition treatment for the recast transaction, respondent concludes, then the deferred exchange should be deemed to have been structured to avoid the purposes of section 1031(f). Respondent suggests that such an analysis ends the inquiry under section 1031(f)(4).

Although respondent's argument has superficial appeal, it is only loosely grounded in the above-quoted, highly elliptical example in the legislative history. Cf. Mandarino, "Reconciling Rulings on Related Party Like-Kind Exchanges", 30 Real Estate Taxn. 174, 175 (Third Quarter 2003) ("Because of the way this example is drafted, it appears not to make the point for which it is offered."). Moreover, respondent's analysis fails to consider the non-tax-avoidance exception of section 1031(f)(2)(C).[11] Because this exception is subsumed within the purposes of section 1031(f), any inquiry into whether a transaction is structured to avoid the purposes of section 1031(f) should also take this exception into consideration.

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[11] As previously discussed, in the context of a direct exchange between related parties, sec. 1031(f)(2)(C) allows the taxpayer to establish that neither the exchange nor the disposition had as

Petitioner seems to suggest that Congress intended section 1031(f) to apply only insofar as the taxpayer fails to "continue its investment" in property that it receives in a related-person deferred exchange. Petitioner seems to suggest that what happens to the relinquished property is of no consequence. We reject any such suggestion as flatly contrary to section 1031(f), which applies with equal force to post-exchange dispositions by either the taxpayer or the related person.

IV. Analysis of the Ocean View and Royal Towers Transactions

Teruya exchanged Ocean View and Royal Towers for like-kind replacement properties formerly owned by Times. A qualified intermediary immediately sold Ocean Vista and Royal Towers to unrelated third parties. Times received the proceeds, plus additional cash from Teruya.

These transactions are economically equivalent to direct exchanges of properties between Teruya and Times (with boot from Teruya to Times), followed by Times's sales of the properties to unrelated third parties. The interposition of a qualified intermediary in these transactions cannot obscure the end result. Petitioner offers no explanation for structuring the Ocean Vista and Royal Towers transactions as it did, and the record discloses no reason (other than seek-

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one of its principal purposes the avoidance of Federal income tax.

ing to avoid the section 1031(f) rules) for Teruya's using a qualified intermediary to accomplish the transactions. Under the circumstances, we are led to the conclusion that Teruya used the multiparty structures to avoid the consequences of economically equivalent direct exchanges with Times. As discussed below, petitioner has failed to establish that avoidance of Federal income taxes was not one of the principal purposes of the Ocean Vista and Royal Towers transactions.

V. Non-Tax-Avoidance Exception

Petitioner argues that Teruya's continued investment in like-kind properties meets the requirements of the non-taxavoidance exception under section 1031(f)(2)(C), as subsumed within section 1031(f)(4). Section 1031(f)(2)(C) provides that there shall not be taken into account any disposition "with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax."[12]

With respect to both the Ocean Vista and Royal Towers transactions, petitioner contends that "there was no intent to disguise an actual sale of the relinquished property in order to reduce or avoid gain recognition on such sale, because a sale of the relinquished property was not intended in the first place." In other words, petitioner contends that from the outset of both transactions, Teruya intended to qualify for deferred like-kind exchange treatment and did not intend to make direct sales of the properties. Petitioner points to the fact that Teruya, Times, Golden, the Association, and Savio agreed in various documents that the Ocean Vista and Royal Towers transactions were conditional on effecting a section 1031 exchange.

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[12] In other contexts involving similar language, we have applied a "strong proof" standard. See, e.g., *Schoneberger v. Commissioner*, 74 T.C. 1016, 1024 (1980). Because it makes no difference to the outcome of this case, we do not apply any heightened standard of proof.

Petitioner's contentions might be relevant in determining whether a transaction is in substance an exchange or a sale of like-kind property. See *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), revg. 38 T.C. 215 (1962). In the instant case, however, they have little relevance. In the first instance, respondent does not contend that the transactions in question were disguised sales or otherwise fail to meet the general requirements of section 1031(a)(1). More fundamentally, section 1031(f) presupposes that an exchange to which it applies otherwise meets the requirements of section 1031(a)(1). See sec. 1031(f)(1)(B). Even if Teruya never intended to make a direct sale of the relinquished properties, this does not mean that section 1031(f) is not implicated or that the deferred sale was not structured so as to avoid Federal income taxes. The economic substance of the transactions remains that the investments in Ocean Vista and Royal Towers were cashed out immediately and Times, a related person, ended up with the cash proceeds.

With respect to the Ocean Vista transaction, petitioner contends that there was no tax avoidance purpose because Times recognized a gain on its sale of Kupuohi II ($1,352,639) that was larger than the gain Teruya would have recognized ($1,345,169) had it sold Ocean Vista directly to the Association for cash.[13] Although Times recognized a gain in the Ocean Vista transaction that slightly exceeded Teruya's gain deferral, it appears that Times paid a much smaller tax price for that gain recognition than Teruya would have paid if it had recognized gain in a direct sale of Ocean Vista. On its corporate income tax return for taxable year ending March 31, 1996, Teruya reported taxable income of $2,060,806. Consequently, if Teruya had made a direct sale of Ocean Vista, the gain recognized on that sale presumably would have been taxable at a 34-percent corporate income tax rate. See sec. 11(b)(1)(C). By comparison, on its Form 1120 for its taxable year ending April 25, 1996, Times reported a net operating loss (NOL) of $1,043,829. Thus, although Times recognized a considerable gain on the Ocean Vista transaction, because of offsetting expenses, it did not incur tax on that gain. Instead, the only tax consequences of Times's gain recognition were reductions of its NOL for its taxable year ending April 25, 1996, and of its NOL carryovers for subsequent taxable years.

In sum, petitioner has failed to persuade us that avoidance of Federal income tax was not one of the principal purposes of the Ocean Vista and Royal Towers transactions.

VI. Conclusion

Petitioner offers no explanation for Teruya's use of the qualified intermediary in the Ocean Vista and Royal Towers transactions. We infer that the qualified intermediary was interposed in an attempt to circumvent the section 1031(f)(1) limitations that would have applied to exchanges directly between related persons. Petitioner has failed to show that avoidance of Federal income tax was not one of the principal purposes of the Ocean Vista and Royal Towers transactions. We conclude that these transactions were structured to avoid the purposes of section 1031(f). Consequently, petitioner is not entitled, under section 1031(a)(1), to defer the gains that it realized on the exchanges of Ocean Vista and Royal Towers.[14]

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[13] The $1,345,169 figure includes approximately $30,061 in claimed selling expenses that Teruya deducted in computing its sec. 1031(a) deferral. Petitioner assumes that Teruya would have incurred these same selling expenses in a direct sale of Ocean Vista.

An appropriate order will be issued denying petitioner's motion to supplement the record, and decision will be entered for respondent.

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[14] On Sept. 8, 2004, petitioner filed a motion to supplement the record with three letters from respondent to petitioner. Each of these letters concerns a technical advice memorandum that involves a multiparty transaction among a taxpayer, a qualified intermediary, and a related person. In a rambling 96-page reply brief, petitioner contends that these letters provide an abundance of evidence that respondent has been improperly administering sec. 1031(f)(4). Because we find that the letters petitioner submitted have no relevance to the issues in this case, we will deny petitioner's motion to supplement the record.

APPENDIX E

UNITED STATES CODE
TITLE 26—INTERNAL REVENUE CODE
SUBTITLE A—INCOME TAXES
CHAPTER 1—NORMAL TAXES AND SURTAXES
SUBCHAPTER O—GAIN OR LOSS ON DISPOSITION OF PROPERTY
PART III—COMMON NONTAXABLE EXCHANGES

[26 U.S.C., 1995 ed.]

§ 1031. Exchange of property held for productive use or investment

(a) Nonrecognition of gain or loss from exchanges solely in kind.

(1) In general.—No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

(2) Exception.—This subsection shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under section

761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property.—For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of—

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) Gain from exchanges not solely in kind.—If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from exchanges not solely in kind.—If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) Basis.—If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

(e) Exchanges of livestock of different sexes.—For purposes of this section, livestock of different sexes are not property of a like kind.

(f) Special rules for exchanges between related persons.

(1) In general. If—

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange—

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) Certain dispositions not taken into account.—For purposes of paragraph (1)(C), there shall not be taken into account any disposition—

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) Related person.—For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) Treatment of certain transactions.—This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

APPENDIX F

UNITED STATES CODE
TITLE 26—INTERNAL REVENUE CODE
SUBTITLE A—INCOME TAXES
CHAPTER 1—NORMAL TAXES AND SURTAXES
SUBCHAPTER O—GAIN OR LOSS ON DISPOSITION OF PROPERTY
PART III—COMMON NONTAXABLE EXCHANGES

§ 1033. Involuntary conversions

(a) General rule.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) Conversion into similar property.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) Conversion into money.—Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe. For purposes of this paragraph—

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection (b) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012.

(B) Period within which property must be replaced.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

* * *

(g) Condemnation of real property held for productive use in trade or business or for investment

(1) Special rule.—For purposes of subsection (a), if real property (not including stock in trade or other

property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

* * *

(4) Special rule.—In the case of a compulsory or involuntary conversion described in paragraph (1), subsection (a)(2)(B)(i) shall be applied by substituting "3 years" for "2 years".

APPENDIX G

CODE OF FEDERAL REGULATIONS
TITLE 26—INTERNAL REVENUE
CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY
PART 1—INCOME TAXES

§ 1.1031(b)–2 Safe harbor for qualified intermediaries.

(a) In the case of simultaneous transfers of like-kind properties involving a qualified intermediary (as defined in § 1.1031(k)–1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

APPENDIX H

Report of the Committee on the Budget,
House of Representatives, to Accompany
Omnibus Budget Reconciliation Act of 1989,
Pub. L. No. 101-239, §7601, 103 Stat.
2106 (1989) [H. R. Rep. No. 101-247,
pt. 6 at 1339 to 1342 (1989)]

Subtitle F. Other Provisions

A. LIMITATIONS ON LIKE-KIND EXCHANGES:

LIMIT NONRECOGNITION ON EXCHANGES OF PROPERTY TO PROPERTY SIMILAR OR RELATED IN SERVICE OR USE; RESTRICT BASIS SHIFTING TECHNIQUES BETWEEN RELATED PARTIES; AMEND HOLDING PERIOD REQUIREMENTS (SEC. 11601 OF THE BILL AND SECS, 1031 AND 1033(G) OF THE CODE)

Present Law

"Like-kind" standard

An exchange of property, like a sale, generally is a taxable transaction. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment (sec. 1031).

In general, any kind of real estate is treated as of like kind with other real estate. By contrast, different kinds of personal property (e.g., equipment and vehicles) are not treated as of like kind. Certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

The like-kind standard contrasts with the standard under section 1033 providing for nonrecognition of gain upon certain involuntary conversions of property (e.g., through destruction, theft, seizure, or condemnation). Other than upon a condemnation of real estate (to which the like-kind standard applies), section 1033 permits nonrecognition of gain to involuntary conversions only if the taxpayer acquires replacement property that is "similar or related in service or use" to the converted property. This standard is significantly narrower than the like-kind standard. For example, unimproved and improved real estate generally are not considered similar or related in service or use.

Related party exchanges

If related parties engage in a like-kind exchange that qualifies for nonrecognition treatment under section 1031, a subsequent disposition of the property by the transferee generally will not affect the nonrecognition treatment of the original exchange. In contrast, present law prevents the use of related party sales to avoid current recognition of gain in the case of installment sales. Under section 453 (relating to the installment method of reporting gain), if an installment sale between related parties is followed by certain dispositions of the property by the transferee, the gain reportable by the original seller will be accelerated.

Holding period requirements

In order to qualify for nonrecognition treatment under section 1031, both the property exchanged and the property received must be held either for use in a trade or business or for investment In *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985), the court held that these holding requirements were met where the taxpayer received property in the liquidation of a corporation and exchanged it shortly thereafter for like-kind property. In Rev. Rul. 77-337, 77-2 C.B. 305, however, the IRS reached a contrary conclusion under similar facts.

Reasons for Change

The committee believes that the "like-kind" standard as applied to exchanges of property is too broad. Under present law, taxpayers have been granted nonrecognition treatment under sections 1031 and 1033(g) (relating to condemned real property) in circumstances where they have significantly changed their investment as a result of the exchange or conversion. The committee believes that it is appropriate to accord nonrecognition treatment only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment. The "similar or related in service or use" standard contained in section 1033 (relating to involuntary conversions) better describes the types of transactions that the committee wishes to accord nonrecognition treatment.

Because a like-kind exchange results in the substitution of the basis of the exchanged property for the property received, related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property in order to reduce or avoid the recognition of gain on the subsequent sale. Basis shifting also can be used to accelerate a loss on retained property. The committee believes that if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, "cashed out" of the investment, and the original exchange should not be accorded nonrecognition treatment.

There are a number of transactions in which taxpayers could use the analysis of the court in *Bolker* as authority for the position that exchanges involving recently acquired property satisfy the section 1031 holding requirements. Because the IRS has taken a position contrary to that of the court in *Bolker*, there is uncertainty regarding the length of time property must be held directly by the taxpayer in order to avoid invalidating the nonrecognition treatment of an exchange under section 1031. The committee believes that taxpayers must directly hold both the property exchanged and the property received for a significant period of time to evidence the requisite continuity of investment purpose.

Explanation of Provisions

"Like-kind" standard

The standard for nonrecognition under section 1031 is conformed to the standard under section 1033 which applies for purpose of nonrecognition on involuntary conversions. Thus, in order to qualify for nonrecognition under section 1031, the property that received must be "similar or related in service or use" to the property that is transferred. The like-kind standard also is replaced with the "similar or related in service or use" standard in the case of a condemnation of real estate (sec. 1033 (g)). Foreign real property will be treated as not similar or related in service or use to U.S. real property for purposes of sections 1031 and 1033. In addition, an exchange of improved for unimproved land (or vice versa), or an exchange of improved properties of a different use, such as an exchange of an office building for a drive-in theater, generally will not qualify as an exchange of properties which are "similar or related in service or use." On the other hand, an exchange of unimproved land held for investment for other unimproved land held for investment, a unitization of oil and gas property, an exchange of an office building for another office building, or an exchange of a bridge (with a charge for usage) and its approaches for another bridge (with a charge for usage) and its approaches, generally will qualify as an exchange of properties which are "similar or related in service or use."

Related party exchanges

If a taxpayer exchanges property with a related party (as defined for purposes of sec. 267) and the taxpayer would otherwise be eligible for nonrecognition treatment with respect to the exchange of such property under section 1031, and within two years of the date of the last transfer which was part of the exchange, either the related party disposes of such property or the taxpayer disposes of the similar or related property received in the exchange from the related party, then the original exchange will not qualify for nonrecognition under section 1031. Any gain or loss not recognized by the taxpayer as of the date of the original exchange will, subject to the loss limitation rules of section 267, be recognized as of the date of the subsequent disposition. Adjustments to the basis of the properties involved in the exchange also will be made as of the date of the subsequent disposition.

A disposition of the property will not invalidate the nonrecognition treatment of the original exchange if such disposition is due to the death of either party or the involuntary conversion of the property (within the meaning of section 1033), provided that the original exchange occurred before the threat or imminence of the conversion. A disposition would include, however, all other transfers of the property, such as tax-free transfers to a corporation (pursuant to sec. 351) or to a partnership (pursuant to sec. 721), unless it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax. A disposition also includes indirect dispositions of the property, such as by means of the disposition of the stock of a corporation or interests in a partnership that owns the property.

Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.

The running of the two-year holding period will be suspended during any period with respect to which a party's risk of loss with respect to the property is substantially diminished.

Holding period requirements

In order to qualify for nonrecognition under section 1031, the property that is exchanged must have been directly held for use in a trade or business or for investment at all times during the one-year period ending on the date of the exchange, and the property that is received must be directly held for a purpose similar or related in service or use to that of the property relinquished at all times during the one-year period immediately after the exchange. Thus, for example, in order to qualify for nonrecognition treatment under section 1031, a partnership which has received property in an exchange must hold the property for at least one year before distributing the property to its partners and partners receiving a distribution of property from a partnership must hold the property for at least one year before exchanging such property.

The disposition and "risk of loss" rules described above with respect to related party dispositions will apply for purposes of the one-year holding period.

Effective Date

The provisions relating to section 1031 apply to transfers after July 10, 1989, and the provisions relating to section 1033 apply to dispositions (within the meaning of section 1033(a)(2)(E)(ii) after that date.

The provision does not apply to transfers pursuant to a written binding contract in effect on July 10, 1989 and at all times thereafter before the transfer or disposition. For this purpose, a written contract which, on July 10, 1989, and at all times thereafter before the transfer, obligates the taxpayer to transfer the property to another party will not fail to qualify as a binding contract solely because it provides in the alternative for an exchange or a sale or solely because the property to be received in the exchange was not identified on or before July 10, 1989.

APPENDIX I

Rev. Ruling 2002-83
Internal Revenue Service (I.R.S.) Revenue Ruling
Published: December 9, 2002
2002-2 C.B. 927; 2002-49 I.R.B. 927

Section 1031.—Exchange of Property Held for Productive Use or Investment, 26 CFR 1.1031 (k)-1: Treatment of deferred exchanges.

Related party like-kind exchanges. Under the facts described, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under section 1031(a) of the Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

ISSUE

Under the facts described below, is a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party entitled to nonrecognition treatment under § 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property?

FACTS

Individual A owns real property (Property 1) with a fair market value of $150x and an adjusted basis of $50x. Individual B owns real property (Property 2) with a fair market value of $150x and an adjusted basis of $150x. Both Property 1 and Property 2 are held for investment within the meaning of § 1031(a).

A and B are related persons within the meaning of § 267(b).

C, an individual unrelated to A and B, wishes to acquire Property 1 from A. A enters into an agreement for the transfers of Property 1 and Property 2 with B, C, and a qualified intermediary (QI). QI is unrelated to A and B.

Pursuant to their agreement, on January 6, 2003, A transfers Property 1 to QI and QI transfers Property 1 to C for $150x. On January 13, 2003, QI acquires Property 2 from B, pays B the $150x sale proceeds from QI's sale of Property 1, and transfers Property 2 to A.

LAW AND ANALYSIS

Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. Under § 1031(d), the basis of property acquired in a § 1031 exchange is the same as the basis of the property exchanged, decreased by any money the taxpayer receives and increased by any gain the taxpayer recognizes.

Section 1031 and the regulations thereunder allow for deferred exchanges of property. Under § 1031(a)(3) and § 1.1031(k)-1(b) of the Income Tax Regulations, however, the property to be received by a taxpayer in the exchange (replacement property) must be: (i) identified within 45 days of the transfer of the property relinquished in the exchange (relinquished property) and (ii) received by the earlier of 180 days after the transfer of the relinquished property or the due date (including extensions) of the transferor's tax return for the taxable year in which the relinquished property is transferred.

Section 1.1031(k)-1(g)(4) allows taxpayers to use a qualified intermediary to facilitate a like-kind exchange. In the case of a transfer of relinquished property involving a qualified intermediary, the taxpayer's transfer of relinquished property to a qualified intermediary and subsequent receipt of like-kind replacement property from the qualified intermediary is treated as an exchange with the qualified intermediary.

Section 1031(f) provides special rules for property exchanges between related parties. Under § 1031(f)(1), a taxpayer exchanging like-kind property with a related person cannot use the nonrecognition provisions of § 1031 if, within 2 years of the date of the last transfer, either the related person disposes of the relinquished property or the taxpayer disposes of the replacement property. The taxpayer takes any gain or loss into account in the taxable year in which the disposition occurs. For purposes of § 1031(f), the term "related person" means any person bearing a relationship to the taxpayer described in § 267(b) or 707(b)(1).

Section 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The legislative history underlying § 1031(f) states that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment."

H.R. Rep. No. 247, 101 superst Cong. 1 superst Sess. 1340 (1989).

To prevent related parties from circumventing the rules of § 1031(f)(1), § 1031(f)(4) provides that the nonrecognition provisions of § 1031 do not apply to any exchange that is part of a transaction (or a series of transactions) structured to avoid the purposes of § 1031(f)(1). The legislative history underlying § 1031(f)(4) provides:

> If a taxpayer, pursuant to a pre-arranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within 2 years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031. Id. at 1341.

Accordingly, under § 1031(f)(4), if an unrelated third party is used to circumvent the purposes of the related party rule in § 1031(f), the nonrecognition provisions of § 1031 do not apply to the transaction.

In the present case, A is using QI to circumvent the purposes of § 1031(f) in the same way that the unrelated party was used to circumvent the purposes of § 1031(f) in the legislative history example. Absent § 1031(f)(1), A could have engaged in a like-kind exchange of Property 1 for Property 2 with B, and B could have sold Property 1 to C. Under § 1031(f)(1), however, the non- recognition provisions of § 1031(a) do not apply to that exchange because A and B are related parties and B sells the replacement property within 2 years of the exchange.

Accordingly, to avoid the application of § 1031(f)(1), A transfers low- basis Property 1 to QI who sells it to C for cash. QI acquires the high-basis replacement property from B and pays B the cash received from C. Thus, A engages in a like-kind exchange with QI, an unrelated third party, instead of B. However, the end result of the transaction is the same as if A had exchanged property with B followed by a sale from B to C. This series of transactions allows A to effectively cash out of the investment in Property 1 without the recognition of gain.

A's exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of § 1031(f) and, under § 1031(f)(4), the non-recognition provisions of § 1031 do not apply to the exchange between A and QI. A's exchange of Property 1 for Property 2 is treated as a taxable transaction. Under § 1001(a), A has gain of $100x, the difference between A's amount realized on the exchange ($150x, the fair market value of Property 2) and A's adjusted basis in the property exchanged ($50x).

HOLDING

Under the facts described above, a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under § 1031(a) of the Internal Revenue Code if, as part of the transaction, the related party receives cash or other non-like-kind property for the replacement property.

DRAFTING INFORMATION

The principal author of this revenue ruling is Martin Scully, Jr., of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Scully at (202) 622- 4960 (not a toll-free call).

APPENDIX J

Tax Analysts, Tax Notes
Volume 79, Number 8 Monday, May 25, 1998
ABA Tax Section—Sales, Exchanges & Basis:
Recent & Future Guidance, page 949
79 Tax Notes (TA) 949 (May 25, 1998)

ABA TAX SECTION MEETING

Officials Discuss Recent and Future Guidance on Exchanges

Insights from government officials on recent guidance as well as possible future guidance highlighted the May 16 meeting of the Sales, Exchanges, and Basis Committee.

The first panel, on section 1031 and related party exchanges, looked at TAM 9748006 in which the IRS concluded that an individual was not entitled to nonrecognition because his mother was involved in the multiparty exchange. Howard J. Levine of Roberts & Holland, Washington, said the TAM is significant because it's the first under the related-party rule of section 1031(f). He wondered about the possible inadvertent implications of the ruling.

Kelly Alton, IRS special counsel to the assistant chief counsel (income tax & accounting), could not understand the fuss over the TAM because the case at issue was not a typical situation. Unlike most exchanges, she stressed, the point of this one was "real tax avoidance." The qualified intermediary's (QI) only role in this exchange was to disguise a related-party exchange.

Alton also said the government is troubled by the inconsistency between sections 1031(f)(2) and 1031(f)(4). Adam Handler, of Sidley & Austin, Los

Angeles, incoming committee chair and one of the drafters of section 1031(f), said he was "troubled by the confusion." He suggested looking at the *Coastal Terminal* decision and the committee reports on the provision.

Committee chair Ronald Platner of Streich Lang, Phoenix, then brought up LTR 9814019. Alton noted this was the first ruling approving a reverse exchange, but cautioned that the facts were ambiguous as to the time periods involved. She warned the committee not to read anything into the ruling beyond a single tax year.

Platner asked about possible guidance on reverse exchanges. Alton said the government was interested; the subject was submitted to the business plan drafters but "didn't make the cut." She urged the committee to lobby to get this item on next year's plan.

Another recent ruling of interest is LTR 9812013, which addresses the issue of acceptable "routine financial services" provided by the QI. Alton noted that it was clearly routine for the QI in this case—a financial institution—to disburse funds from an account for the purchase of nonreplacment property. She added that this is the first ruling on this subject.